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Market Failure and Political Failure

James M. Buchanan

I. Introduction

On several occasions, I have summarized the theoretical welfare economics of the mid-century decades as "theories of market failure" and the public choice economics of the post-middle decades as counterpart "theories of political failure." This statement captures the central thrusts of the two research programs, but, nonetheless, the statement is confusing because it suggests that both positive analyses of institutional operation and criteria for operational failure are comparable over the two applications.

The criterion for success, and hence, failure, applied to the operation of a market order by the practitioners of theoretical welfare economics is widely recognized to be efficiency in the utilization of economic resources. But both the meaning and the normative appropriateness of the efficiency criterion can be questioned. If "efficiency" is attained only through the working of the market process, how can it be set up as an independent criterion with which to evaluate the workings of the process itself? Even if this basic question is somehow finessed, justificatory arguments must be advanced in defense of the efficiency norm.

In extension to politics and political process, can something akin to allocative efficiency be invoked at all? Or is a totally different success criterion appropriate here? If so, how is it to be defined? And, once defined, how can the two potential institutional "failures"

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be assessed on some comparable bases until and unless the evaluative norms are themselves reduced to a common scalar?

The paper is organized as follows. In Section II, I briefly examine some of the basic issues that arise in assessing market or political failure. The heart of the paper is contained in Section III in which an attempt is made to assess the prospects for political correctives for a single particular example of market failure, utilizing the standard efficiency criterion. Section IV is very short, but it introduces a discussion of changes in the basic structure of rules, in the constitution, that seem to be suggested if any prospect for attaining the efficiency gains promised upon diagnosis of either market or political failure is to be realized. Section V is also brief; it introduces the alternative of setting up some distributional ideal to evaluate the performance of market and political structures. The discussion in both Sections IV and V is severely restricted in this paper, since adequate treatment of either of these two areas of inquiry would require full-length treatment quite apart from the main thrust of the argument here.

II. Ideal Points and Feasibility Sets

Even if we remain within the confines of political economy, when we examine either market or political failure (or success), we must confront issues that have been centerpieces of philosophical argument for many centuries. Can an ideal be defined independently from that which can be observed? And if this question is answered affirmatively, can an ideal state that lies admittedly beyond the limits of the set of feasibly attainable states serve as a standard of evaluation for an observed state?

These questions may be examined with specific reference to the identification of market failures stemming from theoretical welfare economics. Consider efficiency in the utilization of an economy's resources—can idealized efficiency be defined in other than conceptually formal terms? We can, of course, state specifically the necessary conditions that must be met in order to satisfy the ideal. Resources are placed in their most highly valued uses when units of each homogeneous resource yield identically valued returns in all uses to which they are put. Values are equalized on all margins of adjustment; marginal rates of substitution in final use are equalized with marginal rates of transformation in production.

But what is homogeneity among units of any resource? Do we define homogeneity by an observed equalization of market prices? If we do, how can any observed differences in prices be employed as a criterion for an absence of allocative efficiency? Until and unless

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the economist presupposes independent knowledge about preference functions and production functions, he cannot define idealized efficiency. And if this epistemological limit to analysis is acknowledged, how can any market be judged to fail? Quite apart from this epistemological barrier to the very definition of efficiency, there remains the necessary dependence of the value-maximizing allocation of resources on the premarket distribution of endowments among persons. Acceptance of efficiency as a norm for success or failure carries with it implied normative support for (or at least acquiescence in) the initial distribution of endowments, or else it requires that corrective steps embody distributional objectives over and beyond those defined by the efficiency norm itself.

For purposes of discussion here, I shall assume, with the theoretical welfare economists, that the required information about preference and production functions may be presupposed, and that the premarket distribution of endowments be accepted as the basis from which value-enhancing changes are to be evaluated. Idealized efficiency can then be defined independently of any observation of market adjustment processes, and it would seem proper that this norm be used as a success indicator. Even within these limits, however, is it appropriate to use this idealized efficiency norm as a means of evaluating that which is observed? If the norm is so employed, market "failure" may be readily identified. Almost all observed market arrangements generate results that fall short of achieving the ideal. The reasons are familiar. Such an assessment of failure does not, however, carry any implication for ultimate institutional or policy change until and unless a pattern of results from an alternative set of arrangements demonstrated to be feasible can be shown to exist. If the attainment of the idealized efficiency norm is shown to require technological-institutional and/or behavioral characteristics that cannot be incorporated within the feasibility set, how much help is provided by resort to the norm as a criterion of success or failure?

III. Political Correctives for Market Failure: The Case of External Diseconomies

The theoretical welfare economists of mid-century did not raise this question because they assumed, implicitly, that the political alternative to the unimpeded operation of the market itself operated ideally. That is to say, it was simply presumed that "failures" in market arrangements could be ideally corrected by politically directed adjustments in the rules guiding market participants.

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The prospect that any feasible political corrective for market failure might also fail when compared against the ideal standard of efficiency was not examined. Some positive theory of the workings of observed political process is required before this essential step in a comparative institutional analysis can be taken. The theory of public choice has, in a sense, made such an analysis possible. It remains nonetheless surprising that public choice economists have not concentrated more attention on the identification and analyses of political failures for purposes of making more specific comparisons with familiar market failure propositions.[1]

I propose to introduce a single, highly stylized, simplified, and familiar model of market failure. There exists a small, but fully competitive, industry that produces a final good, X, which trades at price, P_x, in full equilibrium. No resources are specific to this industry, and there are no rents received by owners of resource inputs, even short-run quasi-rents. Consumers secure some rents from the availability of this product on the market at the competitive price. The production of X, however, generates spillover or external damages on many persons. The producing firms do not take these external diseconomies into account in their decisions. Hence, relative to the idealized efficiency norm, there are too many resources devoted to the production of X. In traditional Pigovian language, marginal private costs faced by the firms are less than marginal "social costs."

The question then is: Will politicization of this external diseconomy ensure correction? For purposes of simplicity in exposition, I shall initially assume that the control instrument is a per unit tax or subsidy on the industry's output. The constitution is altered to allow such a tax or subsidy to be imposed by the workings of a political decision rule.

I shall assume that all persons in the economy and polity have full information as to the incidence and effects of the tax, and, also, that all persons vote or otherwise act politically to further their own measured economic interest. In the market failure setting postulated, under these restricted assumptions, politicization of the externality

[1]I raised the issue in an early paper, but there my primary concern was with the presence of externalities in the political decision process generally and not with attempted political correctives for specific market failures. See my "Politics, Policy, and the Pigovian Margins" (1962).

In a second early paper, Gordon Tullock and I analyzed comparative market and political failure under reciprocal external economies. The analysis was, however, largely concentrated on a world-of-equals model, and we did not examine the politics of distribution that accompany attempts to correct for market failures. See Buchanan and Tullock, "Public and Private Interaction under Reciprocal Externality" (1965).

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will ensure that the efficiency norm is satisfied only under an extremely narrow set of circumstances. If *all* persons in the polity are damaged by the external diseconomy, and are also *equally* damaged; if *all* persons are also consumer-buyers of the industry's product, and also purchase *equal* quantities; if the revenues from the tax are shared *equally* among *all* persons, and without pass-through loss, then politicization will ensure full correction for the market failure, regardless of the political decision rule. In this setting, it will be in each and every person's interest to impose the idealized Pigovian tax. Market price will rise precisely by the amount of the tax; production will fall; some resources will shift to other uses. Revenues from the tax will be shared equally by all persons. Each person will gain an amount measured by the size of the familiar welfare triangle.[2]

Once we move beyond the world-of-equals restrictions on the model, politicization will *not* operate to correct for the efficiency loss imposed by the nonpoliticized operation of the market. Distributional effects must enter the calculus of individuals, and their interests must include these effects as well as the potential gains and losses in efficiency, as usually measured. And *distributional* effects necessarily introduce potential conflicts of interests among persons. Hence, the predicted results of the operation of any political decision rule will depend both on the rule itself and on the relative sizes of those persons in the sets that secure distributional gains and losses under the imposition of a tax on the industry's product, along with the disposition of revenues.

The political economist might be prompted to inquire into prospects for working out some structure of compensations such that, even in the setting that violates the highly restricted equality assumptions, general agreement might be reached on the idealized solution dictated by the efficiency norm. Suppose that all relevant members of the polity can be classified into three sets: (1) buyers of the industry's product; (2) sufferers of the external damage generated by production; and (3) persons totally unaffected by the industry, neither buyers nor sufferers of damage.

We know that, if the external diseconomy is Pareto relevant, the members of (2) should be able to compensate fully the members of (1) for the losses incurred in the price change consequent on the

[2]The result depends on the presumption that the unit tax will modify behavior in purchasing the good, but that the return of tax revenues in the form of transfers will *not* influence behavior, despite the direct relationship between the size of an individual's transfer payment and his rate of purchase. In other words, only the tax exerts a substitution effect.

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reduction of industry output.[3] Note, however, that this compensation will require payment over and above the return of all revenues collected under the efficiency-inducing unit tax rate to members of (1). Such a return of revenues will still leave purchasers with net losses measured by the familiar welfare triangle. The restriction to the single control instrument must be dropped if general agreement on the Pareto-superior shift to the idealized efficiency solution is to be attained.

Note, further, and more importantly, however, that even if political implementation is limited to the "exchange" between members of (2) and (1), and if some payments above and beyond return of tax revenues are arranged, the structure of compensations (return of revenues plus subsidies) must include individualized adjustments among persons in (1) to allow for variations in the quantities of the good purchased and in the elasticities of demand over the relevant range of price change. These purchase-related differentials in transfer payments would be required to ensure that income effects be neutral for all members of (1), quite apart from the arbitrary assumption that there is no substitution effect of the transfer payments, despite the required direct relationship between the sizes of the payments and the individual rates of purchase. If substitution effects are extended to purchase-related transfers, so that all members of (1) fully reckon that any excess outlay generated by the higher price will be returned as a transfer, then the whole attempt to "correct" behavior via the imposition of the unit tax will fail from the outset.

In order to ensure that the levy of the tax modifies behavior, as well as for more general political reasons, the revenues from the tax would likely be returned to persons on some broad-based sharing scheme, even if the transfers could be limited to members of a single class, such as members of (1). But, once any such departure from the idealized scheme is introduced, however, distributional interests of persons are introduced that might be directionally counter to any efficiency-inducing "exchange" through political process.

Even such partial political intervention as represented by the return of revenues generally to members of (1) would seem, however, to be highly improbable. Persons in (3), those who are totally unaffected by the external diseconomy, would almost necessarily be included in the political choice process, directly or indirectly, and they will have interests that are exclusively distributional. Suppose that the political economist proposes the levy of an efficiency-inducing unit

[3]Through our simplifying assumption about the absence of producers' rents, the incidence of the tax falls exclusively on buyers.

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tax on the industry's output, with revenues returned to buyers of the product, with the differentiation as required, along with some supplemental payments to cover the losses measured by the welfare triangles. In other words, assume that the "exchange" between members of (1) and (2) meets all of the requirements for agreement, so that the political implementation of this "exchange" promises to generate the idealized efficiency solution. But persons in (3) may not acquiesce in the observed payment of cash transfers to members of (1). Persons in (3) will insist on sharing in the funds made available from the apparently newly discovered revenue source. To the extent that members of (3) are brought into the revenue-sharing group, members of (1) will oppose the whole scheme, again on strictly distributional grounds. No longer would they be fully income-compensated for the change in price of the good consequent on the change in industry output. And members of (2), those who suffer the external diseconomy, can scarcely be expected to "bribe" all members of (3) sufficiently to ensure the viability of the efficiency-inducing rate of tax. Politically, the efficiency-inducing tax seems a nonstarter.

We can extend the analysis and try to make some very general predictions about politicization of the externality in the example. We retain the three-set classification of persons, and we now introduce the assumption that the political choice process works as if it were a simple majority voting rule. For purposes of simplicity in exposition, assume initially that the three sets are of equal size, and that a person holds membership in only one set. We can array the policy options or alternatives as follows:

1. T_o — Leave the competitive result alone; levy zero rate of tax.
2. T_e — Impose efficiency-inducing rate of tax; distribute revenues equally among all members of politically dominant coalition.
3. T_m — Impose revenue-maximizing rate of tax; distribute revenues equally among all members of politically dominant coalition.
4. T_p — Impose prohibitive rate of tax.

We can now examine the ordinal ranking of these alternatives by the members of the three sets. There are two possible arrays, depending on the relationship of T_e and T_m. In the first array below, I assume that the efficiency-inducing rate of tax falls below the revenue-maximizing rate of tax; in the second array, this relationship is reversed. The rankings are as follows:

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Set (1) Buyers	Set (2) Sufferers	Set (3) Unaffected
	(I: $T_e<T_m$)	
T_o	T_p	T_m
T_e	T_m	T_e
T_m	T_e	T_o, T_p
T_p	T_o	
	(II: $T_e>T_m$)	
T_o	T_p	T_m
T_m	T_e	T_e
T_e	T_m	T_o, T_p
T_p	T_o	

It is evident from examination of these arrays that, under the assumption that the sets are equi-sized, T_m is the stable majority choice. The preferences are single-peaked. There is a two-group majority coalition favoring T_m over either of the other alternatives.

This result is relatively insensitive to changes in the distribution of revenues from the tax that is levied and to the amount of pass-through wastage in the fiscal process. The ranking for members of (3) will remain as indicated if there is any positive net transfer to them. And note that members of this set are the median preference holders; the interests of those persons in sets (1) and (2) are strictly opposed in either of the two rankings. Members of (1), the buyers, will have the ordinal rankings indicated if there is any drainage of revenues from their hands, and, in addition, if they do not secure the required supplementary payments over the simple return of all revenues. Sufferers (2) will always prefer the prohibitive tax, except in those cases where they might, as major sharers in revenues, prefer the revenue-maximizing tax.

The T_m result is also relatively insensitive to changes in the relative sizes of the three groups. So long as neither (1) nor (2) is sufficiently large, on its own, to enforce a majority choice, the members of (3) are in control, even if their size is small. If either (1) or (2) is sufficiently large to impose a majority choice, then T_o or T_p will emerge. Note that, in no case will T_e emerge from the operation of the voting rule. The efficiency-inducing rate of tax is dominated by one of the other three alternatives, under any and all variations in the relative sizes of the three sets.

If the efficiency-inducing rate of tax falls below the revenue-maximizing rate (I in the arrays above), then politicization of the externality will generate an allocative result that involves final industry output below that which is Pareto efficient. Whereas the uncor-

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rected market result involves industry overproduction, the politicized result involves underproduction relative to the standard efficiency norm. If the efficiency-inducing rate of tax lies above the revenue-maximizing rate (II in the arrays above), politicization will involve industry output that remains above that which the efficiency criterion would indicate to be ideal but below the output in the uncorrected market. In this case, politicization is at least directionally corrective.

The failure of politicization to correct for the externality seems clear in the single example examined in detail here. But does the divergence between the predicted political solutions and those that might satisfy the efficiency criterion depend on the "institutional structure of externality"?[4] The existence of *any* surplus, whether producers' or consumers', that results from the market generation of an activity that exerts large-number externalities, negative or positive, will ensure that distributional aspects enter directly in any political control process. Participants in the political decision process seek to maximize their own utilities, given the instruments available to them. They may only be secondarily interested in their shares in the efficiency gains that idealized market correction might promise.[5] Models other than the single one analyzed in some detail above might, of course, be introduced to demonstrate the generality of the results.

But the overall conclusion remains the negative one that politicization of market failures will be highly unlikely to secure the objective of moving the economy toward satisfaction of the idealized efficiency norm so long as the political process itself embodies the expressions of differential interests by citizens.

IV. Can the Potential Efficiency Gains Be Captured?

As the discussion has indicated, there will remain unexploited efficiency gains in the operation of the market and/or the political process. In both cases, we can imagine or dream of idealized allocative changes that could prove advantageous to all parties in the economy or polity. And, as the simple analytics of the Pareto classification shows, there must exist means of moving from what is to an optimal solution in such a way that no person is harmed by the change. But the accomplishment of any such change may require a

[4]In an early paper entitled "The Institutional Structure of Externality" (1973), I examined several models in terms of the sources of market failure in each case. I did not, however, follow up and examine the same models for possible implications under political control.

[5]For a general recognition of this point, see Flowers and Danzon (1984).

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complex and sophisticated structure of highly personalized tax and subsidy schedules, compensations, side payments, and transition rules that are beyond the capacity of either market or political structures as we know them. It may not be institutionally feasible to capture more than some fraction of the efficiency losses that market and political failures seem to impose upon us.

The very existence of such gains should ensure, however, that there will remain a role for the political economist who might be able to advance proposals that will embody mutuality of gain.[6] If he reckons on the predicted operating properties of both ordinary markets and ordinary politics, the political economist will presumably be led to consider reform at the level of basic institutional-constitutional rules, where the distributional aspects can be mitigated if not totally eliminated from consideration. Why should anyone, as a potential participant in political process, be interested in abstract efficiency? As the analysis has suggested, the participant will, in particular cases, place primary emphasis on distributive shares. If, however, general rules are considered, rules that are to be applied to a large number of separate cases of potential political control, the participant does have an interest in an efficient structure. Since he cannot know how, distributionally, he will be affected on any one from the whole set of issues that may emerge for political decision, the individual will be led from consideration of his own interest to promote efficiency in the predicted working properties of the inclusive institutional structure.[7]

If the inclusively defined set of institutional constraints is treated as exogenous, and hence not subject to change, there is a sense in which any observed allocation is efficient. To the extent that participants maximize their utilities, given the constraints within which they act, there remain no efficiency gains to be exploited. Reference to potential efficiency gains must, therefore, imply a belief that some constraints are subject to change.[8]

V. The Efficiency Norm and Distributive Standards

To this point, the discussion has been exclusively contained within an acceptance of the efficiency norm as the basis for evaluating insti-

[6]In a very early paper, I defined the role for the political economist to be that of seeking out possible proposals for change that would command consent. See my "Positive Economics, Welfare Economics, and Political Economy" (1959).

[7]The logical foundations of this bridge between efficiency and individual self-interest were presented in Buchanan and Tullock (1962).

[8]For further discussion, see my "Rights, Efficiency, and Exchange: The Irrelevance of Transactions Cost" (1984/1985).

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tutional performance. The epistemological claims of the theoretical welfare economists have been presupposed, even though these claims appear to me to be open to serious challenge at a more sophisticated level of philosophical inquiry. For most neoclassical economists trained in the post-welfare economics era, there is nothing unusual or unacceptable in using the efficiency norm for evaluating the performance of the market process. These same economists might, however, question the use of the same norm to evaluate politics. Why should politics be expected to generate efficiency in resource use? As noted, however, unless the same scalar is employed, how can relative "failure" or "success" be judged at all?

Some distributional norm or standard is perhaps the most likely alternative to efficiency. By comparison here, however, there seems to be little or no agreement in a precise definition of a distributive ideal. If such an ideal could be defined, then the operation of the market might be compared with that of political process. Once again, both processes would surely be judged to fail to achieve the norm.

In application to the achievement of any distributive norm, however, care must be taken to define the distributive potential of the two separate institutions. The market operates, and in so doing, it generates a particular distribution of the surplus that emerges from social cooperation in the usage of the premarket resource endowments held under legally defined ownership of separate persons. The market cannot, and does not, act directly on the distribution of the endowments of persons. By contrast and comparison, politics may make little or no distinction between the distribution of the surplus emergent from social cooperation and the distribution of initial endowments among persons. There is no constraint on the operation of ordinary politics that is at all akin to that imposed by the legal structure on the operation of the market. When, therefore, the market is compared unfavorably with politics from the criterion of some distributive ideal, the relatively open-ended potential for political redistribution is seldom noted.

Even when such comparisons are made properly, however, the discussion is often concentrated on the prospects of idealized attainment of the distributive ideal rather than on any realistic analysis of the distributional changes that might be implemented in the workings of democratic politics. As is the case with efficiency, persons are not likely to express interests in abstract distributional ideals for the society in general when they participate in political decisions. They are likely, instead, to seek to further their own well-defined interests. Whether or not political process will, indeed, be able to "improve" on market-determined distributive results remains an open issue that

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social scientists have been surprisingly reluctant to analyze seriously.[9] Until and unless politics, as it works, and not as it might ideally be imagined to work, can be demonstrated to generate better distributive results than the market, "better" in terms of some reasonable acceptable standard, advisers should be reluctant to encourage distributional politics.

This paper does not deliver the assessment of analytical developments in the context of the experience of the quarter century, the assessment that was my assigned subject. The analysis has been aimed at raising more questions than it attempts to answer, and the paper's message is perhaps best interpreted as a sketch for a research program that seems hardly to have been commenced. By inference, the argument might be taken as a criticism of the naiveté of both the market-failure welfare economists and the market-works-politics-fails stance of many modern public-choice and new neo-classicial economists. By comparison with idealized standards, both markets and politics fail. Recognition of this simple point is a mark of "scientific" progress. Such recognition directs attention to comparative institutional analysis and to the structure of the set of constraints within which either market or political behavior takes place. The domain of "constitutional economics" beckons; let us get on with it.

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[9]For a preliminary attempt to analyze transfer or redistributive political process in positive terms, see Brennan and Buchanan (1985, chap. 8). Further work on this topic is in planning stages. For a related argument that concludes that the market process may be the only distributional system that avoids conflict, see Usher (1981).

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Ideology and Political/Economic Institutions

Douglass C. North

Economics has little to say about ideology and even less to say about how it affects choices and economic performance. By ideology I mean the subjective perceptions that people have about what the world is like and what it ought to be; ideology therefore affects people's perceptions about the fairness or justice of the institutions of a political economic system. By institutions, I mean the humanly devised constraints on repeated human interaction, that is, the rules of the game—both formal rules and informal norms of behavior and the way they are enforced.

In the real world we regularly observe commitment or alienation resulting in individuals living up to agreements when they would be better off defecting or, conversely, devoting resources to altering the rules when they could be free-riding. Subjective perceptions would make no difference were individuals perfectly constrained by rules, but in fact both institutions and the costliness of measuring performance permit subjective perceptions of fairness and justice to matter. They affect economic outcomes both directly, by the attitudes of the labor force toward shirking, cheating, stealing, sabotage; or conversely, working hard, living up to the spirit as well as the letter of agreements; and indirectly, via participation in the political process.

While this essay is concerned with ideological attitudes and their consequences in terms of both their direct effect on the quantity and

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quality of output and their indirect effect through the political process, the primary focus is upon the latter. I begin with a skeletal analytical framework of the exchange process and its implications for the subjective perceptions individuals have of the fairness and justice of institutions. Then I examine the Second Economic Revolution, which transformed the productive potential of Western economies, and the consequent implications for ideological perceptions. In the last section I explore some of the implications of this analysis.

Transaction Costs and the Fairness and Justice of Institutions

Ever since Adam Smith, economists have recognized that the gains from trade are the key to the wealth of nations. What has been missing from the analysis of economists until recently is the recognition that this exchange process is not costless. Indeed, a key argument to be advanced in this paper is that the costs of transacting associated with the exchange process are a fundamental source of the success or failure of economies. When economists have looked at transaction costs, they have typically misunderstood the role such costs play, either regarding them as unproductive—as in the classical notion of unproductive labor—or contending that transaction costs exist but are passive and therefore unimportant, that is, neutral with respect to the consequences for economies. Both of these perceptions, as well as the traditional neoclassical perception that the exchange process is costless, have fundamentally misdirected research in economics. There have always been gains from trade, as classical international trade theory has taught, but there have also always been obstacles to achieving the gains from trade. These obstacles are not just transportation costs, which as they declined in history should have led to growing specialization and division of labor; they also are the costs of human organization and the problems of human cooperation and coordination.

These problems of cooperation and coordination can be illustrated by comparing two polar extremes in the exchange process. In one, simple personal exchange, individuals engage in repeated dealings with each other or otherwise have a great deal of knowledge about the other parties in the exchange process. The costs of transacting in such a society are very low because of the dense social network of interaction. Cheating, shirking, opportunism, all characteristics of modern industrial organization, are limited or indeed absent, because they simply do not pay. Norms of behavior are seldom written down and formal contracting typically does not exist. Indeed, there is little

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need for formal, specific rules. While measured transaction costs in such societies are low (although there may be substantial costs of societal cooperation in small-scale societies), production costs are very high, because specialization and division of labor are limited by the extent of the market defined by personal exchange.

At the other extreme, a world of specialization and division of labor, interdependency characterizes the entire structure, and therefore the exchange process extends over time and space. Impersonal exchange characterizes the total exchange process, with people having no individual knowledge of the other partner in exchange. In this form of exchange, the costs of transacting therefore may be high, because of all the problems of measuring what one is getting in exchange and of ensuring that the contracts will be carried out by the other party. In consequence, the gains to be achieved by cheating, shirking, opportunism, etc., rise dramatically. In successful Western societies, these costly aspects of transacting are minimized by elaborate institutional structures devised to constrain the participants and so make the exchange worthwhile. As a result, we have formal contracts, bonding of participants, guarantees, trade names, elaborate monitoring systems, and effective enforcement mechanisms. In short, we have well-specified and well-enforced property rights. The resources devoted to transacting are large (although small per transaction), but in consequence the productivity associated with the gains from trade are even greater and are responsible for the high rates of growth that have characterized Western societies. However, it should be pointed out right away that the institutions that have made possible relatively low costs of transacting in turn depend upon even more fundamental political economic institutions, ones that undergird the entire system. It is this complex of institutions that is the subject of the analysis here and that is at issue when we examine the perceptions people have about the fairness and justice of the institutional structure.

The major implication of the institutional structure that makes possible specialization and division of labor and therefore low costs of transacting per unit of exchange is that individuals are able to engage in complex relationships with other individuals about whom they have no personal knowledge. The institutional structure reduces the uncertainties associated with contract fulfillment as a consequence of enforcing reliable forms of exchange. This is possible only as a result of the development of a third party to exchanges, namely government, which specifies property rights and enforces contracts.

Much of the recent literature involved in game theory, in particular the literature that has followed Robert Axelrod's influential book, *The Evolution of Cooperation* (1984), has implied that the develop-

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ment of more complex forms of cooperation is an inevitable process of institutional development. Yet, human economic history does not bear out this optimistic perception of the world. Thoughout history, failures and the inability of societies to develop are far more common than are success stories. Even in the modern world successful economies, as measured by per capita income, are still in the minority. The vast majority of economies remain underdeveloped and are characterized by inefficient systems of exchange. The movement from personal exchange to impersonal exchange poses fundamental dilemmas with respect to societal cooperation. The breakdown of personal exchange is the breakdown not just of a dense communication network, but of communities of common ideological perception and of a common set of rules that all believe in. The rise of impersonal rules and contracts means the rise of the state and with it an unequal distribution of coercive power. Such distribution provides the opportunity for individuals with superior coercive power to enforce rules to their own advantage, regardless of their effects on efficiency. Not only has the rise of the state typically induced inefficient property rights;[1] the growth of specialization has also produced another adverse consequence with respect to human cooperation: with growing specialization, common ideologies and norms of behavior break down as people have increasingly different experiences and hence different perceptions of the world around them.

The creation of new rules does not necessarily provide stable forms of behavior, and in fact the process of adjustment of new formal rules (that is, the devising of norms of behavior that will be consistent with and complementary to rules) is long and slow. It took almost 500 years for the Western world to evolve forms of organization and institutions that made possible the world of specialization that we observe.

Let me summarize the dilemma of cooperation with respect to the development of modern complex economies. There are four major variables involved in the costliness of exchange. The first is the cost of measuring the valuable attributes of the goods and services being exchanged or of measuring the performance of agents. What I mean by measurement here is particular kinds of information that undergirds the efficiency of property rights. Property rights consist of a bundle of rights, and to the degree that we cannot measure precisely what is being exchanged, then the costs of transacting and the uncertainties associated with transacting rise dramatically. Therefore, in

[1]For a theoretical argument on why states typically induce inefficient property rights, see North (1981) chap. 3, "A Neo-classical Model of the State."

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order to have efficient property rights, we must have low cost ways to measure the rights and the performance of agents in hierarchical structures. The immense resources that societies devote to organizations and enforcement would be superfluous in a world where measurement costs were zero. But because such costs are extremely high and at best imperfect, the other variables in the costs of transacting become important.

The second variable in the exchange process is the size of the market, which determines whether personal or impersonal exchange occurs. In personal exchange, kinship ties, friendship, personal loyalty, and repeat dealings all play a part in constraining the behavior of participants and reduce the need for costly specification and enforcement. A handshake suffices for even complex exchange. When these factors are absent, the exchange process becomes more costly. In impersonal exchange, there is nothing to constrain the parties from taking advantage of each other. Accordingly, the cost of contracting arises with the need for more elaborate specifications of the rights exchanged.

The third variable is enforcement. In a world of perfect enforcement, there would be, ideally, a third party impartially evaluating disputes and awarding compensation to the injured party when contracts were violated. In such a world, opportunism, shirking, and cheating would never pay. But such a world does not exist. Because of the costliness of measurement, it is frequently impossible to determine even whether a contract has been violated and if so by whom. Nevertheless, in the modern Western world, the evolution of courts, law systems, and a relatively impersonal body of judicial enforcement has played a major role in permitting the development of a complex system of contracting that can extend over time and space, an essential requirement of a world of specialization.[2]

These three variables determine the cost of exchange as a consequence of an environment in which, according to the neoclassical behavioral assumption, individuals maximize at every margin (that is, if cheating pays, one cheats; if loafing on the job is possible, one loafs; if one could with impunity burn down a competitor, one would do so). It is hard to imagine that complex organization could be possible at all if this assumption actually described human behavior;

[2]The critical stumbling block in the evolution of modern economies is the creation of stable political and judicial systems that devise and enforce property rights that encourage complex contracting over time and space (i.e., that permitted the Second Economic Revolution). This paper is concerned only with the subsequent role of government as a result of this economic revolution, not with the conditions that made possible the initial political framework.

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the costliness of measuring performance, of fulfilling contracts, and of enforcing agreements would make complex exchange too costly. However, the neoclassical assumption also is that preferences or tastes are constant. But ideological attitudes, the fourth variable, are not constant. The strength of ideology can be measured by the premium people are willing to incur rather than free-ride. This premium varies according to one's views about the fairness or justness of the rules of the game and therefore the degree to which one believes one should live up to contracts or not. Appeals to justice and fairness do matter, otherwise we would be at a loss to explain a good deal of schooling as well as the immense investment made by politicians, employers, labor leaders, and others in trying to convince participants of the fairness or unfairness of contractual arrangements. Our understanding of ideology is still sketchy, but one point appears to be significant to this analysis. Specialization and division of labor, as mentioned above, produce divergent perceptions of reality and hence contrasting and conflicting views of the fairness and justice of institutions. Needless to say, the importance of ideology is a direct function of the degree to which the measurement and enforcement of contracts is costly. If the measurement and enforcement of contract performance can be done at very low cost, then it makes very little difference whether people believe the rules of the game are fair or unfair. But because of the costliness of measurement and enforcement, people's perceptions about the fairness and justice of institutions play a big role and are a major part of the analysis of this essay.

The Second Economic Revolution: Implications for Ideological Perspectives

In the past century, increase in the size of government has been a feature of the growth of all the major high-income Western economies. Accordingly, any explanation that is going to be a useful model must take into account that the growing role of government in the economy has been a characteristic feature of all successful high-income countries. Hence, particularistic explanations that have focused on the uniqueness of any one country, like the United States, have missed the point. There is something about the way in which Western economies have evolved that has encouraged the growth of government. I will begin this discussion by looking at the Second Economic Revolution,[3] which has been the underlying source of the growth of

[3]The First Economic Revolution was the development of agriculture, which began in the Eighth Millenium B.C.

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modern economies, then describe the growth of government that has accompanied this revolution, and conclude with questions about the extent to which growth of government can be explained by the traditional neoclassical models of interest group pressures on political systems and the part that ideological perceptions may in fact have played.

The term "economic revolution," used here, is intended to convey three distinct changes in an economic system. These are a fundamental change in the productive potential of a society as a consequence of a basic change in the stock of knowledge and an equally basic change in organization to realize that productive potential. In fact, the Second Economic Revolution made realizable the underlying assumption in neoclassical economics: that new knowledge could be produced at constant cost and that substitutions at all margins could be possible and as a result could create sustained growth without diminishing returns to a fixed factor. The technology that characterized this revolution was one in which there were significant indivisibilities in the production process, with large fixed-capital investment. The technology in fact was first reflected in such early works as J. M. Clark's "Economics of Overhead Costs" in 1923 and Allyn Young's classic article, "Increasing Returns in Economic Progress," in 1928, which discussed the implications of increasing returns. Perhaps the most vivid description of this process has been provided by Alfred Chandler in his book, *The Visible Hand.* Let me briefly quote Chandler's summary (1977, p. 281):

> The rise of modern mass production required fundamental changes in the technology and organization of the processes of production. The basic organizational innovations were responses to the need to coordinate and control the high-volume throughput. Increases in productivity and decreases in unit costs (often identified with economies of scale) resulted far more from the increases in the volume and velocity of throughput than from a growth in the size of the factory or plant. Such economies came more from the ability to integrate and coordinate the flow of materials through the plant than from greater specialization and subdivision of the work within the plant.

Chandler (pp. 282–83) goes on to discuss the integration of mass production with mass distribution:

> As the new mass production industries became capital-intensive and management-intensive, the resulting increase in fixed costs and the desire to keep their machinery or workers and managerial staff fully employed increased pressures on the owners and managers to control their supplies of raw and semifinished materials and to take over their own marketing and distribution. The changing ratio of

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> capital to labor and of managers to labor thus helped to create pressures to integrate within a single industrial enterprise the process of mass distribution with those of mass production. By 1900 in many mass production industries the factory, works, or plant had become part of a much larger enterprise. In labor-intensive, low-level technology industries most enterprises still operated little more than a factory or two. But in those industries using more complex, high-volume, capital-intensive technology, enterprises had become multifunctional as well as multiunit. They had moved into marketing of the finished goods and purchasing and often the production of raw and semifinished materials. These enterprises did more than coordinate the flow of goods through the processes of production. They administered the flow from the suppliers of raw materials through all the processes of production and distribution to the retailer or ultimate consumer.[4]

What Chandler has effectively described was the organizational structure that accompanied this new technology, but his account is only a part of the story. Also significant to the managerial revolution was an attempt to devise sets of rules and compliance procedures that would reduce the transaction costs that attended the new technology.

Realizing gains from a world of specialization required occupational and territorial specialization on an unprecedented scale, and in consequence the number of exchanges in the exchange process grew exponentially. In fact, in order to realize the gains from the productive potential associated with a technology of increasing returns, one had to invest enormous resources in transacting. The U. S. labor force between 1900 and 1970 grew from 29 million to 80 million; but manual workers (that is, production workers) increased only from 10 million to 29 million, while white-collar workers grew from 5 million to 38 million. Between 1870 and 1970, the resources devoted to the transaction sector grew from 25 percent of GNP to more than 45 percent of GNP.[5]

Let me briefly elaborate some of the problems of measurement and enforcement problems that led to the growth of the transaction sector. Control over quality in the lengthening production chain and a solution to the problem of increasingly costly principal-agent relationships were necessary to realize the gains from specialization. Much of the technology was designed to reduce transaction costs by substituting capital for labor or by reducing the degrees of freedom of the worker in the production process and by automatic ways of

[4]This citation of Chandler is discussed in detail in North (1981, pp. 175–76).
[5]See Wallis and North (1986).

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measuring the quality of intermediate goods. Time and motion studies and scientific management had their initiation during the early 20th century. An underlying problem was that of measuring inputs and outputs so that one could ascertain the contribution of individual factors and the output at successive stages of production as well as in final outcomes. For inputs, there was no agreed-upon measure of the contribution of an individual input. Equally, there was room for conflict over the consequent payment to factors of production. For outputs not only were there residual unpriced outputs (that is, wastes and pollutants), there were also complicated costs of specifying the desired properties of the goods or services produced at each stage in the production process.

Another problem associated with the new technology was that one had large fixed-capital investments with a long life and low alternative scrap value. As a result, the exchange process of contracts had to be extended over long periods of time, which entailed uncertainty about prices and costs and the possibilities for opportunistic behavior on the part of one party or another in exchange.[6]

The revolutionary technology of the 19th century radically altered the production and distribution of goods and services. Accompanying this technology was an enormous increase in specialization and division of labor and, in consequence, radical changes in relative prices, which altered the traditional structure of the polity, of the family, and of economic organization. A variety of interest groups that emerged from this expanding division of labor led to political pluralism. The demand for new institutional forms of organization to undertake functions undertaken by the family in traditional economic organization could not be completely realized by voluntary organizations because of moral hazard, adverse selection, and the demand for public goods. The growth of government is a function of demand arising from the redistributive effort of a growing number of effective interest groups and the inability of voluntary organizations to completely meet the new needs of the family and of economic organization. The supply of government was made possible by new technology, which, coupled with the consequence of growing market specialization, lowered the costs of government's monitoring of income and wealth and increased the efficiency of government taxation. In the case of the United States, the growth in supply was accompanied by a shift from local to federal expenditures that simply reflected the growing

[6]See North (1981, pp. 177–79) for elaboration of the consequences of these changes.

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size of the market and therefore the necessary locus of government activity.[7]

Such a summary is a traditional neoclassical account of the growth of government. It is one in which is reflected an interest-group story. That is, the market system is, as a consequence of competition, inherently unstable and tends toward self-destruction. Competition leads to sharp fluctuations in the terms of exchange and, in the case of the labor market, to unemployment, inducing interest groups to attempt to influence or control policies of the state in the interests of reducing competitive pressures. Certainly there is enormous evidence to support this perception of the growth of government, and it is one that is compatible with a great many of the stories that neoclassical economists have told about the growth of government. But is it the whole story?

When one looks at the consequence of the Second Economic Revolution, not just in the United States, but throughout the Western world, one finds it is associated in the 19th and 20th centuries with a massive reaction against market economies and market forms of resource allocation. Labor movements throughout Western Europe were predominantly socialist and communist. Peasant and farm groups, if not actively hostile to market economies, have at least spearheaded movements to protect themselves for market competition. Third-world countries, as they emerge to become independent, have shown little enthusiasm for market forms of resource allocation. Even in those countries where predominantly market economies have developed, government has grown. Can it all be explained by an interest-group model? An alternative to this explanation is that characteristics peculiar to the exchange relationship in market competition induce massive alienation. Moreover, market competition energizes groups to overcome the free-rider problem and to gain control or at least participate in control of the state.[8]

Some Unresolved Questions

Will the market economy continue to self-destruct? Will the Schumpeterian view that a capitalist economy by its very success

[7]See North (1985) for a more detailed treatment of the growth of government.

[8]It was Karl Polanyi who, in *The Great Transformation* (1957), first made a forceful case that a market society would tend to self-destruct. Polanyi argued that the market-based society which dominated the Western world in the 19th century was inherently unstable because the commoditization of land, labor, and money (via the international gold standard) destroyed the social fabric of society. See North (1981, pp. 180–83) for an elaboration of this hypothesis and an analysis of the ideological consequences of the Second Economic Revolution.

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will lead to socialism become a reality? Schumpeter, I suspect, would have been surprised at the vitality of the market system some 45 years after *Capitalism, Socialism, and Democracy* (1942) was written. In order to have some confidence in our predictive ability with respect to ideological perceptions, we need to have a much more sophisticated knowledge of a number of aspects about economics than we currently possess. We need a more complicated behavioral assumption in economics than we have so far employed. The simple view of expected utility theory of wealth-maximizing players with perfect knowledge about the world around them must be replaced by our modern perception that, in fact, individuals have imperfect information and hold subjective perceptions that are heavily colored by their own imperfect information and that influence their perceptions of the fairness and justness of the political economic system.

Let me expand upon this point by quoting a recent comment by Herbert Simon (1986, pp. S210–11) on the behavioral foundations of economics, which he delivered at a recent conference of economists, psychologists, and other social scientists exploring the behavioral foundations of economic theory:

> If we accept values as given and consistent, if we postulate an objective description of the world as it really is, and if we assume that the decisionmaker's computational powers are unlimited, then two important consequences follow. First, we do not need to distinguish between the real world and the decisionmaker's perception of it. He or she can predict the choice that will be made by a rational decisionmaker entirely from our knowledge of the real world and without a knowledge of the decisionmaker's perceptions or modes of calculation (we do, of course, have to know his or her utility function).
>
> If on the other hand we accept the proposition that both the knowledge and the computational power of the decisionmaker are severely limited, then we must distinguish between the real world and the actor's perception of it and reasoning about it. That is to say, we must construct a theory (and test it empirically) of the processes that generate the actors' subjective representation of the decision problem he or she frames.
>
> The rational person in neo-classical economics always reaches the decision that is objectively or subjectively best in terms of the given utility function. The rational person of cognitive psychology goes about making his or her decisions in a way that is procedurally reasonable in the light of the available knowledge and means of computation.

This behavioral assumption is important because to the degree that the market system has been a success story, and it surely has been in Western economies, the "rational" expectation would suggest that

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people would increasingly have confidence in the relative efficacy of the market as compared to alternatives in solving their problems. That is, the feedback process between performance and subjective perceptions should reinforce support for market solutions, particularly in light of the widespread knowledge about the relatively dismal performance of socialist economies.

However there is more to this issue. Overall successful performance of an economy conceals a mixture of gainers and losers—or at least relative losers. Competition may be a positive sum game, but that is of little comfort to those who are submerged in the "creative destruction" of a dynamic competitive system. Despite the elegant welfare propositions that economists advance, gainers seldom compensate the losers in the real world, and it is not surprising that the losers may come to the conclusion that the system is unfair. It is important to understand that "efficiency," the buzz word of economists, is in the world of the sociobiologist associated with survival, but also survival at the expense of the less fit. But in the political economy world of human beings there is abundant reason not to expect such evolutionary outcomes. What distinguishes humans from animals is that the political decision processes are a feedback loop in the chain by which to alter (but not eliminate) the essential characteristics of the competitive-evolutionary process. There is no normative implication to the above statement. I am not assuming that biological fitness is good or even that economic efficiency is good; only that, to the degree you believe the sociobiologists' story (and that is what it is), you should recognize that it does get altered by the political economic institutional structure. The way it gets altered is a function of the subjective perceptions of the players and the way those perceptions are translated via the political process into economic outcomes.

Essential to this translation is that the political economic institutions facilitate this process by lowering the cost of expressing and effecting ideological convictions. Ideological behavior is different from wealth-maximizing behavior in that it may entail a wealth or income sacrifice in return for carrying through one's convictions. But institutions frequently permit voters, legislators, and judges, all of whom determine policies, to express their ideological convictions at little or no cost to themselves. Ideology does appear to obey the law of demand.[9] That is, the higher the price one pays for one's convictions, the less will ideological conviction be important. But since individual votes do not count, one can express one's strongly held

[9]See Nelson and Silberberg (1987) for empirical support of this proposition.

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conviction simply at the cost of going to the polls; legislators are only imperfectly constrained by voters, and judges are deliberately protected from interest group pressures by lifetime tenure. Ideological conviction would be significant even if all the players paid the price of their conviction, but in fact the political judicial system guarantees that ideas and ideologies are far more important in determining outcomes.

What is at issue are a number of (mostly) unresolved questions about the sociology of knowledge and the political process. Chief among these are the following two categories:

1. What determines individual perceptions about the justice or fairness of political/economic systems and how are they related to the overall performance of an economy and to variously positioned individuals in the economy?
2. How do these perceptions get translated into political policies? Who votes, why do they vote, and how do votes relate to outcomes? Do legislators mirror voter preferences or their own preferences (and is there a difference)? What is the relationship between political policies and economic outcomes, and how do these outcomes affect economic performance and in turn (to come full circle) individual perceptions about the fairness and justice of the system?

To the extent we can answer these questions, the relationship between the exchange process and individuals' perceptions of the fairness and justice of institutions will be better understood.

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Contract, Utility, and the Evaluation of Institutions

J. Charles King

When I first began to study moral and political philosophy nearly 30 years ago, these subjects were, in the English-speaking world at least, more or less depressed areas. That these subjects have undergone a renaissance, at least in the United States, has often been noted. This renewal has been demonstrated to me by the fact that most European intellectuals I meet today are now familiar with the names of Rawls and Nozick.

In my own view, a crucial factor in the renewed interest in political philosophy as an academic discipline was a reopening of dialogue between some philosophers and some economists. It has resulted in large measure from the fact that at least two outstanding economists of our time, namely, F. A. Hayek and James Buchanan, are also extremely important political philosophers.

In an article entitled "Rights, Contract, and Utility in Policy Espousal," Leland Yeager (1985) advances and defends a version of utilitarianism that he uses to launch a very strong critical attack on Buchanan's contractarian political economy.[1] As a person originally trained in philosophy, I find Yeager's critique of Buchanan fascinat-

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[1]Yeager (1985) also attacks various writers in the contemporary natural rights tradition, but I will not be concerned with that aspect of his argument. The critiques of Yeager by Tibor Machan (1987) and Hartmut Kliemt (1987) are of considerable interest, but I have approached the matter somewhat differently and have resisted the temptation to lengthen an already long paper by commenting on their criticisms. Professor Yeager replied to these critics in Yeager (1987).

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ing because it seems to reveal a genuine *philosophical* disagreement. As best I can tell, the political disagreements between Yeager and Buchanan are minor. In general, they favor regimes of extensive liberty characterized by private property, free markets, and restricted government activity. But as Yeager describes it, his philosophical disagreement with Buchanan is extreme.

Yeager (1985) maintains for example:

> Striving for clarity may justify some harshness: except in brief and untypical passages, Buchanan tries to conceal his employment of and to shirk his responsibility for values that he, like anyone, must be employing when he recommends anything, even when what he recommends is process rather than substance as the criterion for appraising institutions and policies [p. 266].
>
> I assert not that contractarianism is flatly wrong but that it disguises its affinities with utilitarianism by repulsive and unnecessary fictions [p. 267].

The second quotation from Yeager points the way toward the thesis I want to suggest. I shall argue that when carefully considered, Yeager's kind of utilitarianism and Buchanan's contractarianism turn out to be versions of a comparative institutions approach to political philosophy offered from different points of view—Yeager's from that of the observer, Buchanan's from that of the participant. I would even say, uncautiously, that they are equivalent views in that, given the same assumptions about information, they yield the same conclusions. They may often use different information, however, since what I call a difference in point of view marks a considerable epistemological difference about intersubjective judgments of what is good or valuable.[2] I shall suggest that this fact provides fundamental lessons about the appropriate role of political philosophy and its relation to social science.

In section I, I strive to understand and to clarify Yeager's own version of utilitarianism. In so doing, I hope also to draw attention to the importance of the great differences between Hume and Bentham, even though both are often listed as utilitarians in textbooks. This difference is of much more than merely antiquarian importance. In section II, I examine Yeager's critique of contractarianism, suggesting modification in regard to those points in which I agree with Yeager. Section III builds on the foregoing sections to argue for my

[2]After completing the writing of this paper, I heard the Fourth Virginia Lecture on Political Economy delivered by Professor Yeager at George Mason University on April 5, 1988. He suggested in that lecture that the two views under consideration are the same. I think that claim goes too far and that the epistemological difference I mention here and discuss below is very important.

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principal thesis, and section IV discusses the lessons we are able to draw about the role of political philosophy and the intellectual defense of liberty.

I. Yeager's Utilitarianism

Yeager states explicitly that he is a rule, not an act, utilitarian. He also allies himself with Hume and Hayek but rejects Bentham. Nevertheless, his own exposition leaves me with numerous questions about just what his own utilitarianism asserts. His criticisms of Buchanan are such that we must clearly understand Yeager's own position before we can try to settle the dispute.

To put Yeager's view squarely before the reader, I begin by quoting at length from his most recent (and most careful) statement of his position (Yeager 1987, pp.269-70):

> Utilitarianism invokes comparisons among alternative sets of institutions, laws, traditions, patterns and maxims of behavior, and traits of personal character. It approves or disapproves of them according as they tend to support or to subvert the kind of society that affords people relatively good opportunities to succeed in making satisfying lives for themselves. Institutions and practices that facilitate fruitful cooperation among individuals pursuing their own diverse specific ends score ahead of ones that make for destructive clashes. "Social cooperation" . . . is so nearly essential to individuals' success in their own diverse pursuits that it is a nearly ultimate criterion of institutions, ethical rules, and so forth . . . .
>
> But social cooperation is only a nearly ultimate criterion. It is instrumental toward something more completely ultimate, something simply taken as desirable because no further argument for its desirability is possible. I can only take stabs at labeling that ultimately desirable "something": it is individuals' success in making good lives for themselves, or fulfillment, or satisfaction, or life appropriate to human potentiality. No single word is an adequate label; but when a single word is required, "happiness" is the traditional choice . . . .
>
> The conceivability of these alternatives shows that the utilitarian criterion is not vacuous, while their implausibility strengthens the utilitarian case. Anyone who knows a plausible and appealing alternative to the utilitarian criterion is hereby challenged to state it clearly.

Utilitarianism as Moral Philosophy

We should first be quite clear that Yeager's theory as stated here is normative. It is a theory of moral and political philosophy and must be understood as such. Moral philosophy and political philosophy

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seem, at best, strange and, at worst, silly to many economists because political philosophy is a fundamentally different kind of intellectual inquiry from positive or explanatory science. In classical terminology, moral philosophy is an activity of practical rather than theoretical reason. In modern terminology, this means that moral philosophy does not adopt the standpoint of observer trying to understand why certain actions take place, but rather takes the standpoint of agent trying to decide what to seek or how to act.

This difference leads to several substantial differences between political philosophy and positive science, but there is no reason that such differences have to include (as some seem to suspect) rigor of reasoning or clarity of exposition. A description of why one might philosophize about morality is perhaps in order. It seems to me a simple truth about human beings that they hold and act on beliefs about such things as how they should treat each other.

Most of my readers would be shocked, I think, if in the discussion of this paper, I simply assaulted those who disagreed with me and drove them from the room. We think that such a use of force in ordinary human relations is wrong, or that it is not the sort of thing one should do. Yet we all know that even such obvious commonplaces may be open to doubt. We might begin to wonder, for example, if restraining ourselves from assaulting such bounders as are disagreeing with us is not mere timidity; if more direct action over time might not purge intellectual exchange of much silly and inconsequential dross. In that case, we may be led to ask ourselves if we really have good reason for our practice of restraint. In so doing, we are taking the first step toward moral (and political) philosophy.

But the inquiry will be different from the inquiry of positive science. In empirical science, one has the check on theory provided by observation and experimentation. I am able to test the hypothesis that gasoline is not a flammable fluid and get quite a definite answer. But especially since Kant, much moral philosophy has been written on the supposition that moral principles must be established a priori. I think this fact is what makes much moral philosophy seem strange and even silly. It has the air of theorizing without any check from reality.

I have argued for many years that such an approach to moral philosophy is empty. Moral principles purport to guide our actions, but this in and of itself should put a substantial check on wild moral theorizing. A moral theory which applies principles that fail to make a claim on our actions is empty. To be at all plausible, a moral theory must be linked to the goals people actually hold. Even though the case is not exactly analogous to the way that experimentation and

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observation place a rein on scientific theorizing, it is close.[3] If a political philosophy tells me it is my duty to support all persons less fortunate than I, and I actually feel no concern for such persons, then its injunction is hollow to me. But much of what is written as moral philosophy does just this. It tries to get people to do what they do not, all things considered, want to do.

Yeager, however, is not at all guilty of such unrealistic moral theorizing. He appeals only to our own critical experience as hardheaded scientific persons. He tries to make it very clear when he is talking normatively and when empirical evidence is relevant to his claims. He makes human happiness the ultimate value of his system and admits that it is a value for which no further reasons can be given beyond asking who would reject it and what he would put in its place (Yeager 1987, p. 270). But naturally, we need not declare ourselves enemies of human happiness in order to examine carefully the exact test that Yeager proposes for guiding our actions in that direction.

Yeager's Rejection of Bentham

Yeager leaves no doubt that he is a utilitarian but is not a Benthamite. He rejects the suggestion usually imputed to Bentham that one should judge each individual action by its likely consequences for the production of pain and pleasure. (I am not at all sure whether this interpretation is fair to Bentham, but that is another story.)

As usually understood, Bentham held the following theses:

1. Pleasure and pain are the only measures of what is good or valuable for an individual.
2. The measure of what is good for a community of individuals is the *sum* of the goods of all the members of the community.
3. The right action to take, including the action of establishing measures of government, is always that which is expected to lead to the greatest possible sum of good in the community of persons affected by it.[4]

To me, it seems undeniable that these three theses form the classical expression of utilitarianism as Bentham introduced it as a moral philosophy.[5] Later writers from John Stuart Mill onward have changed various elements of the three to advance what seemed to them more plausible versions of what they still called utilitarianism.

[3]I discuss these points in some detail in King (1982).

[4]Bentham's own words surely support this interpretation. See, for example, Bentham (1948, chap. 1, secs. 1–10).

[5]J. S. Mill claims to have introduced the term "utilitarian" to signify one opinion—that of taking utility as a standard. Naturally, this is too vague to help us as a standard of how the term is to be used now. See Mill (1962, first author's note in chap. 2, p. 257).

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Yeager rejects the third thesis in favor of a much greater emphasis on rules and institutions. He says repeatedly that he is a rule utilitarian. As usually understood, a rule utilitarian would substitute the following thesis for (3):

3a. The right action to take, including the action of establishing measures of government, is always that one which most nearly accords with that set of rules and institutions which is expected to lead to the greatest possible sum of good for the community of persons affected by the rules and institutions.

Yeager seems to think that this change accomplishes two ends, which I have trouble seeing. First, he seems to think that adopting rule utilitarianism allows him to avoid the usual objections raised against utilitarianism. Second, he seems to think that it puts him in company with Hume and Hayek in adopting a comparative institutions approach to political philosophy. But Yeager's interpretation raises the question of denying not thesis (3) but thesis (2), which holds that the good of a group is the sum of the goods of the individuals making up the group. (For Bentham, of course, we may say here "pleasure" for "good" for that is the effect of thesis (1).)

Yeager complains frequently of what seem to him unfair attacks on utilitarianism that amount to caricature, but the plain fact is that any moral theory which includes thesis (2) is open to just the kind of attack Yeager regrets. Any theory which sets as the standard for a group the sum of the individual goods (whether pleasure, utility, or whatever is taken as good) of the persons composing the group is inherently liable to sacrifice some members of the group for others in the group. To resolve this difficulty, the contrast between act and rule utilitarianism is irrelevant.

The logic of the situation stares one in the face. If the standard is to be determined by the magnitude of the sum of a + b + c, etc., it matters little whether the values of a, b, and c are 3, 4, 5, or whatever. The *sum* matters. Thus 25 + (−2) + (−3) is preferable to 3 + 4 + 5 as a solution. In that case, b and c *ought* to be sacrificed in order to create the greatest balance of good over evil! A switch to average utility does not alter this basic fact. John Rawls (1971, p. 27) was clearly correct when he wrote that utilitarianism (at least of this kind) does not take the distinction between persons seriously.

If I read correctly, Yeager more or less agrees with what I have said about aggregate utility, but I am unable to accept his view that rule utilitarianism, in and of itself, leads to the rejection of aggregate utility. He asks how one could write operationally meaningful rules for sacrificing individuals for the greater good of "society" (Yeager

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1985, p. 273). But such rules are easy to imagine. Consider, for example, such common phenomena as sugar quotas or milk price supports, which are usually justified as serving a social purpose, but naturally at a cost to consumers. The fact that the beneficiaries are quite real individuals only reinforces the point; it does not change the fact that these are actual rules for sacrificing some for others. (Naturally, I am not suggesting that Yeager would endorse these particular rules.)

I have spent perhaps too much time on this point, since presumably few of my readers believe it possible to make the kinds of interpersonal utility comparisons required for aggregate utility measures to be made in any case. But I have done so because employment of thesis (2) has been the most nearly common thread in those writers who have been called utilitarian in the philosophical tradition. Many utilitarians have disagreed with Bentham on thesis (1)—that pleasure is the only good. Even Mill welshes a bit on this. Further, rule utilitarianism was probably the view of Mill and has been adopted by many others. Thus it is perhaps understandable that, for many of us, adherence to some form of thesis (2) has come to stand as the chief mark of utilitarianism.

Nonetheless, Yeager's utilitarianism rejects this thesis—as indeed any plausible moral or political view ought to do—and we must try to understand his view on its own terms. I will try to do so by considering his invocation of Hume, but first we should note that Yeager also parts from Bentham (and Mill) in regard to thesis (1).

Yeager on Happiness

In the material quoted above, Yeager characterizes happiness as that ultimate for which no further argument can be given. But he explains this as "individuals' success in making good lives for themselves," "fulfillment" or "satisfaction," or "life appropriate to human potential." To be fair, Yeager treats this phenomenon as one which he cannot better describe. On the other hand, he has also insisted that "it is a researchable and discussable empirical judgment that happiness is served by institutions which facilitate voluntary cooperation" (Yeager 1985, p. 278). I think it is clear then that we must press somewhat more on this question of Yeager's ultimate criterion if we are to understand his view.

Yeager's idea of happiness is much more complex than that of Bentham and Mill, even with all of Mill's complications. Their view is stated straightforwardly in Mill's essay *Utilitarianism*. By happiness, Betham and Mill mean "pleasure, and the absence of pain; by unhappiness, pain, and the privation of pleasure" (Mill 1962, p. 257).

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This reminds us of how Yeager's version of utilitarianism has almost none of the carefully interlocking, almost mechanistic features of classical Bethamite utilitarianism. Doubtless, this makes it a stronger theory, but it also makes it more difficult to understand.

Yeager's view apparently is that we can, through observation of actions and critical evaluation of testimony, determine whether people are leading happy or satisfying lives. I have a great deal of sympathy with his approach. It is much more realistic than Benthamite attempts to arrive at criteria for a happy life. Rather, we look to see whether people tend to stay voluntarily in the places where they live, whether they support the government, and such. We also listen to what they say, but correct it for when they are making good sense. As we will see in examining his critique of Buchanan, Yeager is a firm critic of the idea that what people choose is good for them. He does not mean that they should have things imposed on them as a result of this, but he does insist that they may make mistakes about what is good for them which an observer may notice even if they fail to realize it themselves (Yeager 1985, p. 265). Admittedly, I am speculating a bit, but I think Yeager is trying to break out of the mechanistic mold characteristic of Bentham and of the a priori rationalistic mode characteristic of Kant to take once again Aristotle's advice not to require greater precision than the subject of human beings can admit (Aristotle 1941, p. 936).

He may be suggesting that we examine people as we know them and judge whether alternative kinds of institutions make them happy or satisfy them. If I interpret Yeager correctly, then both his failure to say more about happiness—since he intends to give no criterion for it—and his move to discussion of social cooperation become understandable, since he views social cooperation as the primary prerequisite to happiness.

Yeager's Relation to Hume

In explaining how his verison of utilitarianism embodies a "comparative institutions or good society approach," Yeager often quotes Hayek and identifies him as a utilitarian in the tradition of David Hume. Hayek's own relationship to utilitarianism is a complex question, made especially so by the difficulty (for me at least) of knowing how to fit the evolutionary aspects of his thought together with his discussions of utilitarianism and other doctrines of moral philosophy. But we need not examine Hayek's own doctrines here in order to continue our examination of Yeager. I think, however, that it would help to look briefly at Hume's view in order better to understand Yeager's comparative institutions approach.

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As Hayek (1976, p. 18) has clearly pointed out, the term "utility" as it was used by writers before Bentham meant only "usefulness." Indeed, this usage in Hume's time is adequately confirmed by consulting Dr. Johnson's *Dictionary*. As Hayek's discussion shows, the equation of utility with pleasure or happiness as it occurs in Bentham or Mill would have made no sense to Hume. When Hume says, for example, that the entire merit of rules of property results from their utility, he means no more than that they are useful for attaining the purposes of each person affected by them. He quite explicitly says that the usefulness involved is that of whoever is touched by the institution (Hume 1975, p. 218). In Hume, there is certainly a crucial concept of public utility, but I would argue that it is the idea of usefulness to each member of the public. It certainly never has the meaning of summing the interests of the individuals. Hume's discussion simply has no place for such an idea. He discusses property, for example, in such a way as to show the importance of such arrangements to everyone, whatever his place in regard to amount of wealth possessed (Hume 1975, pp. 183-92).

To call Hume a utilitarian is simply to invite confusion if to do so assimilates his view to those of Bentham and Mill. But since Hume does depend upon the usefulness of institutional structures and rules, it may be to his mode of argument that Yeager intends to return.

Summary

If I have understood it correctly, Yeager's view (whether or not we are to call it utilitarian) is that the ultimate criterion in evaluating institutions and rules is the happiness or satisfaction of those who live under them. This means that any given person finds himself living in a culture and subject to a government, neither of which he had anything to do with creating. To evaluate this structure, he must ask himself how human beings fare under this set of institutions as opposed to other realizable possibilities. But, to emphasize again, I assume that by harking back to Hume, Yeager intends to judge in terms of all those who are affected by the institution or rule in question. This sets up a very difficult problem, but working it out will be the task of actual argument using Yeager's theory.[6]

[6]In the lecture mentioned in supra note 2, Yeager offered a criterion drawn from Hayek and Harsanyi which says that his kind of utilitarian seeks to maximize the chances of any person chosen at random. He referred to this possiblity in his original 1985 article (p. 280), but I have omitted that passage to avoid further complication. Various versions of this move fall prey either to what I say about maximization or what I say below in regard to Buchanan on the veil of ignorance.

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Answering this kind of question would take a great deal of empirical and historical research. It also requires difficult judgments about human happiness, but in the end Yeager thinks that is as far as one can go. He asks with some confidence if anyone can suggest another principle. Thus, considerable weight is placed on his criticism of other views. It is, therefore, to his criticism of James Buchanan's contractarianism we must now turn.

Let me emphasize, however, that I have identified Yeager's comparative institutional view as the whole of his utilitarianism. He also says his view can even evaluate traits of character. I leave that claim aside for now and focus on his political philosophy of comparative institutions.

II. Yeager's Critique of Buchanan

Yeager is squarely in the utilitarian tradition, or at least the Benthamite tradition, in one respect. His argument for his own position depends importantly on showing the implausibility of competing positions. It depends on showing that, to the degree they are plausible, they presuppose his own position. In fact, I found a striking similarity between Yeager's argument and that of Bentham (1948, pp. 4-7) in this regard.

Like Bentham, Yeager is an enthusiastic and withering critic. Indeed, his discussion of Buchanan is more like a machine-gun attack than a careful dissection with a scalpel. He quotes and cites so many short passages and offers so many criticisms that it took a great deal of time for me just to look up each passage and read it in context.

Naturally, such an attack is difficult to summarize and evaluate. Yeager does not present a careful statement of his understanding of Buchanan's position but relies on the following three quotations drawn from Buchanan's works in the 1970s to state the basic drift of Buchanan's view:

> To the contractarian that law is legitimate, and just, which might have emerged from a genuine social contract in which he might have participated. That law is illegitimate, and unjust, which finds no such contractual basis [Buchanan 1977, p. 127].
>
> My point is mainly that of emphasizing the use of process, as opposed to end-state results. . . . For Rawls, as for contractarians generally, that which emerges from contractual agreement is just [Buchanan 1977, p. 61].
>
> That is "good" which "tends to emerge" from the free choices of the individuals who are involved. It is impossible for an external observer to lay down criteria for "goodness" independent of the process through which results or outcomes are attained. The evaluation

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> is applied to the means of attaining outcomes, not to outcomes as such [Buchanan 1975, p. 6].

Yeager's critical points can, I believe, be reduced to six, one of which contains several subpoints. In so doing, I have omitted much, but I believe I have captured all the primary charges he makes against Buchanan's contractarianism. I think, however, that it will help the discussion if I first sketch my understanding of Buchanan's contractarian philosophy.[7]

Buchanan's Contractarianism

Buchanan's first principle in political philosophy is the individualist principle of consent, which finds its best-known expression in the Declaration of Independence. This principle holds that legitimate or just government derives its legitimate authority from the consent of the governed. (This principle, a cornerstone of modern political theory, divides it fundamentally from the ancient view that some men are by nature rightfully the rulers of others.)

Buchanan's political philosophy is addressed to individuals finding themselves, as we all do, subject to the power of governments that have developed over time and that we personally have neither consented to nor formed by contract. He holds that each such person should judge the government to which he is subject just and legitimate if he finds that its structure is such that *it could have been* established by a genuine contract in which he participated.

In reaching this decision, the individual takes into account not only his own aims and goals in life but also the fact of the necessity of agreeing with others with different and conflicting aims. (If he wonders why he should do this, he is invited to read his Hobbes.) The exact structure of this hypothetical situation of contract is the most difficult problem of contractarian philosophy, but Buchanan has usually treated it as a constitutional convention, and not as the terribly abstract predicament philosophers such as Rawls have described. This is because Buchanan does not intend to deduce any principles of justice from his contractual situation. Rather, he proposes it as a frame of mind or process from which citizens may address each other in concrete political discussion about the structure of their government.

Thus, Buchanan is committed to the view that differing kinds of constitutions could emerge from the contractual situation, depending

[7]I have drawn this sketch from many years of reading Buchanan, but it is not practical to cite a source for each claim. I have reviewed the various sources cited by Yeager, but two new pieces by Buchanan have recently come to my desk, illustrating the difficulty of being sure one has read everything by him that one should in attempting such a short summary.

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on the values of the persons involved. But this is not to deny that some general facts will govern contractual situations of the kind he describes. The need to agree (learned from Hobbes), the recognition that other people's values may differ markedly from our own, the recognition that voluntary agreement must be mutually beneficial, and the great ignorance of the future under which all human beings labor will always constrain the individuals choosing a constitution. In his Nobel lecture, Buchanan also allowed for a veil of ignorance sufficiently thick that the gap between general and particular interests is bridged (Buchanan 1987, pp. 1433-36).

If the individual concludes that the government under which he lives involves a constitution (whether explicit or implicit) that could have emerged from a contractual situation to which he was a party, then he must view that government as legitimate even when its actions may, at times, displease or harm him. He may use the postconstitutional avenues of political process to seek change or reform. If there are structural elements of the government in whose power he finds himself that he thinks could not have emerged from a contractual situation of the kind described, then he may want to seek constitutional change.

In either case, the starting point is always the status quo with its "implied social contract," that is, its actual distribution of rights and burdens. In Buchanan's view, there simply is no other place to start. Only proposals to change the status quo that can obtain voluntary consent are worth advancing. Sweeping claims of the injustice of the status quo and plans to redistribute to make it "just" have no hope to be accepted voluntarily and are not part of the contractarian frame of mind, which is based on mutual gain from voluntary exchange. Such claims are calls, purely and simply, for revolution—for using force to impose a new order. There may be times when such steps are the best ones to take, but history's record of that kind of revolution is not a happy one.

This sketch is necessarily compressed, but I hope it fairly reflects the chief positions of Buchanan's political philosophy to which Yeager objects.

Yeager's Items of Critique

The following are primary charges against Buchanan.

1. Yeager (1985, p. 265) says that the whole idea of contractarianism seems odd to him at first because it resembles the idea that whatever people freely choose is, in fact, good for them. He points to the well-known fact that we all believe that persons, including ourselves, often choose what in fact is bad for us, but he is careful to caution

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that he does not mean to say this fact would justify imposing choices on others. Frankly, I find this criticism of little weight. Buchanan needs only to maintain that no one else has legitimate authority over others; they must give their own consent. Whether in the view of others (or in his own view later) he judged his own interest badly does not really matter. In the end, I suspect Buchanan would be satisfied to admit that individuals are imperfect judges of their own good, but would insist they are better judges of it than anyone else. On this point, Yeager seems to agree as well, so I see no significant criticism of contractarianism involved.

2. Yeager goes on to object that voluntary agreement is not itself the criterion of what to agree to. He thinks Buchanan creates just such a confusion when he asserts that what emerges from his contractual situation is just. He does not see why results of agreement should be viewed as beyond criticism.

In this case, we again have the confusion introduced by difference of point of view between observer and participant. Buchanan is quite correct from the viewpoint of participant. In his view, the just constitution is that which emerges from a contractual situation in which one was himself a participant. In the negotiation of the contract, one has been guided by one's own aims in life, as well as by the constraints discussed above. Thus one has not taken agreement itself as the criterion of that to which one will agree, but having on other mutifaceted grounds agreed, one sees the outcome as just.

As external observer, Yeager sees only the agreement and is tempted to think agreement has itself become the only criterion of agreement. But this is not the experience of the participant and is not how the contract is determined. Once this further information is provided to the observer, this objection loses its point.

3. In the passage quoted in my introduction, which Yeager himself calls harsh, he charges that Buchanan shirks his responsibility for values he must be employing. This criticism follows Yeager's endorsement of Scott Gordon's charge that Buchanan is trying to derive his "ought" from premises which contain only "is" (Yeager 1985, pp. 265-66).

There are places in Buchanan's early work where one may wonder if he has kept the positive and normative parts of his theories clearly distinct, but in his later work, I simply can find no basis for this charge. His Nobel lecture is, for example, admirably clear in this respect.

I assume that Yeager and Gordon are interpreting Buchanan as saying the fact of agreement makes rules just and thereby deriving "ought" from "is." If, however, Buchanan accepts, as I think he does,

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the principle of consent or individualism as a normative first principle, he has made no confusion of "ought" and "is," nor has he failed to take responsibility for any values. The principle of consent involves a normative claim about justice and legitimacy of government. It implies other individualist value claims. I do not believe that Buchanan has shirked his responsibility for these or has hidden his commitment to individualism. But placing a high value on letting other persons judge for themselves does not commit one to approving what they may judge *from one's own value perspective.* I cannot see how taking this line consistently can be judged as shirking responsibility for one's values.

4. Yeager criticizes Buchanan's rejection of the so-called truth judgment approach to political philosophy as opposed to the process view of contractarianism. Buchanan's position on this point is, in Yeager's view, unfairly critical of the kind of position Yeager himself holds.

Having contrasted the role of politician with that of judge or jury, Buchanan (in a passage quoted by Yeager) states:

> Most reform advocates consider themselves to be engaged in a persuasion effort which, if successful, will produce a coalition that will command sufficient political power to enforce its will. And the reform advocates of this stripe express no moral inhibitions about imposing their preferred outcomes on all of their fellows, independently of expressed agreement or consent. In part, this demonstrated willingness to impose nonvoluntary changes on the existing pattern of entitlements in social order finds its own moral support in some "truth judgment" conception of politics generally. To the extent that the existence of "truth" in politics is accepted, the intellectual problem is one of discover and definition. Once "truth" is found, there is no moral argument to be raised against its implementation. Consent is meaningless in this context. Opposition can be variously characterized as stemming from ignorance, folly, or the exercise of selfish interest. In any case, the views of those who actively oppose the truth-carrying zealots are not treated as worthy of respect. And any requirement to compromise with such views arises only because the reformists might otherwise lack the power to impose "truth" unilaterally [Buchanan 1977, pp. 143-44].

Now it is easy to see why Yeager criticizes this passage, for he himself holds a "truth judgment" view and yet has specifically denied that he is willing to see his truths imposed on others because he thinks that is no way to bring about the happy lives he seeks to promote. There seems to be some right on both sides here. Buchanan's statement that once truth is found, there is no moral argument to be raised against its implementation is too sweeping. It does not account for Yeager's view, according to which part of the discov-

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ered trust is that truths about political and moral matters should not simply be imposed on people. If there is substantial difference between Yeager and Buchanan, Buchanan will have to argue against Yeager in some other way.

But there is, nonetheless, considerable truth in what Buchanan says in the quoted passage. While Yeager and a few others may be exceptions, the majority of political philosophers do write as though one could impose whatever is just if one has or can get the power to do so. Buchanan's view is attractive because it erects a structural barrier against this possibility.[8]

5. Perhaps Yeager's chief complaint against contractarianism is its supposed employment of what he calls "repulsive and unnecessary fictions" (Yeager 1985, p. 267). I shall discuss in turn four cases he mentions.

First, Yeager holds that Buchanan treats an implicit social contract as if it had actual force, thereby legitimating a *status quo* that otherwise is not a product of consent and should be rejected by Buchanan's own principles.

There may be reason to question whether this issue is treated clearly in *The Calculus of Consent*, but in Buchanan's later writings and especially in the essay, "The Use and Abuse of Contract," cited and quoted by Yeager, I can see no room for misunderstanding this point (Buchanan 1977, pp. 142–46).

As I explained above, the concept of implicit contract is nothing more than a way of referring to the kind of contract that is implied by the institutions of the status quo. But Buchanan introduces this notion only as a way of comparing it to other possible contracts. It has no legitimacy because of consent; its legitimacy is only as a starting point. One may disagree with Buchanan on this matter, but I fail to see that he uses a fiction which is either unclear or repulsive. What he has said, if I have understood him, is fairly clear and straightforward. As such it may reasonably be debated.

Second, Yeager also objects to the use of the word "conceptual" by contractarians. He says "it is no mere joke to say that 'conceptually' is an adverb stuck into contractarians' sentences to immunize them from challenge on the grounds of their not being true" (Yeager 1985, p. 271). But when I examine Buchanan's writings, I find "conceptual" used in the contexts cited by Yeager only as a way of making clear the fact that claims are being made about what would be true under

[8]Yeager also suggests that Buchanan is pushed too far toward epistemological relativism by his desire to avoid authoritarianism, but to consider that question would require an excursus into epistemology which is beyond the scope of this paper.

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hypothetical contract that one could accept. It is true that Buchanan makes use of hypothetical reasoning, but his clarity about doing so seems to guard against its abuse. Nor is it reasonable to ask anyone to write or think about subjects relating to human actions without the use of hypotheticals. Human action is goal directed and as such, by its very nature, must ask what would happen *if*.

Third, Yeager is bothered that Buchanan, after introducing the distinction between the constitutional and postconstitutional stage, points out that at the postconstitutional stage, one may not always be happy with the way things work out, but one has no complaint because one agreed to the rules. In such a case, if one commits a crime and is fairly convicted and punished, one may reasonably be said to have agreed to be punished.[9] While this case employs an obvious figure of speech, it conveys a deep truth, and it is difficult to see why such thinking involves fiction.

Buchanan also speaks of "apparent" coercion and "apparent" redistribution in a similar context. Yeager has a point in saying Buchanan, in such instances, is perhaps misleading since the coercion and redistribution are real enough, just as is the punishment. But the case is the same in all three instances. Buchanan wants to call attention to the legitimacy of these uses of force even on oneself because one has agreed to the rules. If the figures of speech are not terribly felicitous, they hardly seem calculated to mislead when read in context.

Fourth, Yeager criticizes contractarianism's use of the concept of a "veil of ignorance" to remove from those in the contractual situation certain information about themselves and their situations. He does not attribute use of such a concept to Buchanan, but refers instead to the works of Rawls, who introduces this concept into the contractarian vocabulary.

Rawls requires that the persons in the hypothetical contractual situation must negotiate behind a veil of ignorance. By this, he means that they must be assumed to be ignorant of their own places in society, their own talents and intelligence, their own wealth and income prospects, and even their own generation. Rawls (1971, p. 136) says this requirement is introduced to "nullify the effects of specific contingencies which put men at odds and tempt them to exploit social and natural circumstances to their own advantage."

Yeager does not attribute the veil of ignorance concept to Buchanan, who has more frequently spoken of a "veil of uncertainty." Buchanan's "veil" refers to the uncertainty about future circumstances that is the common lot of mankind, but which naturally would

[9]On this topic, see also King (1980).

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have an important influence on choices such as those imagined in the hypothetical contractual situation where a constitution to last an indefinitely long span of time is to be chosen. In his Nobel lecture, Buchanan said "behind a sufficiently thick veil of uncertainty, ignorance, or both, contractual agreement on rules that allow for some in-period fiscal transfers seems to be possible" (Buchanan 1987, p. 1436). Since the insertion of "sufficiently thick" leaves this statement somewhat ambiguous, I will leave open what Buchanan does say and proceed boldly to prescribe what he *ought* to say.

Simply put, the veil of ignorance vitiates the whole plausibility of the contractarian approach. Yeager is quite right to criticize it. The veil of uncertainty is simply a way of calling attention to the natural limits of human beings. It is inescapable. The veil of ignorance is a matter of choice. Buchanan indicates this when he implies that we may make it thicker or thinner at will. Rawls says that the veil is intended to structure what the outcome of the contractual situation will be. Buchanan seems to imply that such a device is necessary to make room for the kind of transfers he desires. I think that Buchanan will destroy much of the appeal of his own theory if he moves from the necessary and proper limitations of uncertainty to use of any kind of Rawlsian veil of ignorance.

If Buchanan inserts a veil of ignorance to allow certain transfers, he, in effect, begs the question of the justice of those transfers. He is committed to saying that just rules are the result of agreement. But how can he know prior to agreement how to construct his veil of ignorance. Since a veil of ignorance is not a requirement of nature, as is a veil of uncertainty, we could disagree on how thick it is to be. How are we to decide, save by considerations of justice, that people are not to be allowed to use certain knowledge they have? Rawls clearly is motivated by achieving certain outcomes, and, given the passage quoted above, Buchanan seems possibly to be motivated by achieving them. To take this step seems to me to beg the question and to drop his own oft-repeated insistence on process instead of outcome.

The veil of ignorance is a device to avoid the effects of the status quo. As we have seen, Buchanan argues long and well for the importance of starting with the status quo. The effects of this excellent argument are vitiated if he employs the voluntary veil of ignorance. Moreover, to employ a veil of ignorance would sorely injure one of the most attractive features of Buchanan's position—namely, its clear link to concrete individuals. The first passage Yeager quoted from Buchanan refers to "a genuine social contract in which he might have participated." This passage gives a clear link to the aims and goals

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of actual people as does Buchanan's continued use of the Wicksellian principle of unanimity as an ideal. But to insert a veil of ignorance breaks the relation of the agreement with real people. Even that sternest enforcer of contracts, Thomas Hobbes, might have had second thoughts about a contract made when (somehow) one had been made to forget all the more important facts about oneself. By striking at the relation of real people to the hypothetical contractual situation, the veil of ignorance strikes at the heart of Buchanan's system.

It may be (and I hope is) the case that Buchanan wishes to include under "ignorance" really nothing more than the natural infirmities of the human condition I group under the heading of uncertainty. If so, we could argue over how extensive that ignorance or uncertainty is, but no basic problem between us results. In any case, nothing about the limits of future knowledge keeps us from knowing our current position and a set of probabilities about future positions based on that position and facts about our society.

Someone will surely object that to allow persons in the contractual situation knowledge of their positions carries the injustice of the status quo over into the contractual situation. But this is the point Buchanan has made so well in discussing the necessity of starting with the status quo. To start elsewhere requires force (i.e., revolution), not political philosophy. If we aim to have peace and to proceed by peaceful means, only the status quo is available as a starting point.

It is also worth noting that the injustices of the status quo are often grossly overestimated, at least in discussion in the United States. No one is wise enough to sort out all the lines of past history. I hear a man say he was born unjustly poor because his great grandfather was a slave, but I am unimpressed. My great great grandfather was a slaveholder, but I still did manual labor to earn money for college because my family's circumstances were extremely modest, to say the least. Even if your grandfather had made a fortune, he might have spent it on women and horses or he might have disinherited your line as a bunch of rotters. Such speculations have little to do with justice.

For Buchanan's theory, in line with his emphasis on mutually beneficial exchange, justice should be about removing barriers to the use of the assets you have, not trying to rectify an unreachable past. Such tasks take divine wisdom and should be left to those who have it. For mere humans, it is far better to follow Buchanan's wisdom and start with the status quo. But in that case, Yeager is correct: Buchanan should avoid the veil of ignorance like the plague. He should rest content with whatever transfers, if any, emerge from an agreement to which real people can be party.

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I want to emphasize that the restrictions based on natural uncertainty and on the need for all to agree provide the required protection against attempts by participants to rig the contract in favor of particular interests. These factors provide the necessary bridge between individual and general interests. They are unavoidable and require no supplement from an intentionally imagined veil of ignorance.

At long last, our consideration of Yeager's critique of Buchanan is complete. While it seems to me that Buchanan's theory is left alive and well, nothing we have learned in considering the critique of Buchanan seems to me to undermine Yeager's own approach to political philosophy. I turn now, therefore, to the task of understanding the relationship between them.

III. Institutional Comparison and Evaluative Points of View

In light of our consideration of Yeager's view and Buchanan's contractarianism, I think we can now see that these two views are much more similar than Yeager's critique would have led us to believe. But, of course, that is exactly what Yeager has insisted from the beginning. It was perhaps his use of the term "utilitarian" that made his claim seem farfetched.

When we look at the two actual theories (at least as I have interpreted them), we see that they are both versions of a comparison of institutions approach. This removes them both from the usual Kantian a priori or Benthamite maximization views. Furthermore, their starting points are very similar. They intend to speak to real individuals who find themselves subject to political institutions not of their own choosing and who wish to raise the question of their legitimacy. Both theorists also want to bring to bear on institutional comparisons the lessons of economics, history, and ordinary knowledge of human nature.

Obviously, the great difference between these positions lies in the method they advocate for carrying out institutional evaluations. Buchanan looks to agreement while Yeager seeks to judge what is good for all concerned, but he will only try to persuade them of it, not force it on them. If we look closely, I believe that we have here only a disagreement on the best epistemological approach to what are essentially the same phenomena. Both theories require us to gain knowledge of values of others. Buchanan hopes to find this knowledge revealed in agreement. Yeager hopes to find it by observation of what people do and say.

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This difference is why I characterized the two theories as adopting different points of view toward the phenomena with which they are concerned. Buchanan's view is that of participant. As potential participant in contractual bargaining, he leaves it to the other participants to determine their own goals, but he must be concerned with what other people's goals are in order effectively to bargain, for in the end agreement must be reached.

Yeager thinks he can discover, as outside observer, what will make people happy, but he believes that what he discovers is an expression of their own goals and inclinations—not a pattern he will impose on them.

By citing this difference of "point of view," I intend only to draw attention to what I think are important epistemological differences between Yeager and Buchanan concerning judgments of value. Yeager proposes to make judgments of what people value, and thus what will make them happy by external observation of which their testimony is only a small part of the evidence. Buchanan, on the other hand, rejects this procedure in favor of simply relying on people's testimony (what they will agree to). I suspect that this difference probably results from deep philosophical differences concerning truth and knowledge, but those need not concern us here. If political philosophy must wait for such questions to be resolved before it can proceed, then political philosophy is hopeless.

I suggest that these theories will yield similar results given the same information about the individuals who are affected by the institutions under consideration. I do not suggest that they will always obtain the same information given their different epistemological approaches. Let me offer some reasons to make this claim clearer.

In addition to similarities already mentioned, there are several points at which similar roles are played in the theories by devices that differ because of the different points of view assumed:

1. Yeager's emphasis on the value of social cooperation, which he says is, next to the ultimate principle of happiness, analogous to Buchanan's continued emphasis on the model of voluntary, mutually beneficial exchange. Both sharply reject the competing maximization model.
2. Buchanan's first principle of consent as the basis of legitimate authority is analogous to Yeager's concern with the happiness of each person affected and is a direct result of his rejection of the aggregate version of the happiness principle. Both theories will, then, have to show full regard to the values of every individual. They are both theories of individualism.

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3. In the contractarian view, the need to agree requires a necessary attention to the goals of each, which is analogous to the concern with the goals of each required in Yeager's judgments of happiness. While it may seem important that Yeager's view requires that the observer applying the theory place an equal value on the happiness of all those he surveys, I do not think it matters to the answers the theories yield. Buchanan's participant may place as much or as little value on the values of others as he will, but he must in the end show proper deference to those values because he has read Hobbes and knows of the overriding need to agree.[10] These differences about concern for others may affect the likelihood of getting others to accept the respective theories, but of that I will say more shortly.
4. Finally, both theories must marshal the same kinds of evidence about the workings of institutions in order to carry out their evaluations. In the end, the root relationships are between the actual workings of institutions and the life-goals of individual human beings.

In light of these four considerations, I can find nothing to lead these theories to diverge in the actual evaluation of institutions, save for differences in information about the goals of individuals that may result from their different epistemological approaches in this area or from the natural failings of human investigators.

In spite of the agreement I suggest, these do remain different theories, and they will serve somewhat different rhetorical purposes. But I see no need further to decide between them as political philosophies. Rather, I suggest that each should try its hand at arguing its position and determine which is found more convincing. While it often pains a priori moralists and moral geometers, human life is enormously complex. It may simply be that some people find Yeager's general concern for the values of all more convincing, while others prefer Buchanan's approach, which emphasizes long-run self-interest as a completely acceptable stance in the contractual situation. I certainly found such division among the students to whom I taught moral and political philosophy for many years.

Thus, it seems to me that no further decision between these theories is required. I must confess to taking some personal comfort in this conclusion, since my respect for each theorist is so great that I am pained by the thought of having to disagree with either in the

[10]On Hobbes and the need to agree, see King (1982, pp. 32–34).

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fundamental way Yeager's article first made me think I might have to do.

IV. The Role of Political Philosophy

The examination of the two theories seems of some significance in its own right, but I believe it also teaches important lessons about the most promising approach to political philosophy. I want to explain these briefly.

The comparative institutions approach of the theories we have considered provides a model of the path I believe we should now take in political philosophy. Both theories address themselves to real men and women with real concerns of human life. They try to bring to bear on these concerns the best information we have been able to develop about how human institutions actually work.

This approach is far removed from the legacies of Kant and Bentham (so different and yet so similar). It issues in no formula or simple tests for how to act. It yields no neat geometrical proofs about human affairs. Rather, it recognizes the frailty of the human ability to know. It does, however, confront the messy, complex problems of trying to live together. It may fairly be said to represent a return to the state of political philosophy at the time of Hume and Smith, before the disastrous detours that lead, on one hand, from Rousseau, Kant, and Hegel to Marx and, on the other, from Bentham and Mill to Fabian socialism. Having written some of the most important moral treatises ever penned, David Hume turned to history and political economy. His example is one that political philosophers should again take seriously. What we know of human affairs from history and economics should be primary data for the political philosopher.[11]

I do not intend to suggest that better history and economics will solve all our political problems. Far from that, the need for an appropriate normative framework into which to fit the knowledge gained from social science is a most pressing need. It is this need that I believe the kind of comparative institutions approach represented in the work of Buchanan and Yeager can supply.

In a country with a political structure of extreme freedom and justice, the role of the comparative institutions political philosopher might be primarily negative. He would need only to try to defeat the

[11]I want to note again that this paper concerns political philosophy. I believe that one can develop for moral philosophy a "comparative lives" analogue of the comparative institutions approach stated here. Such a development would need to draw on literature, the great religious sources, and the arts, as well as on history and economics. The presentation and defense of such a framework is a task for another occasion.

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constructionist and utopian schemes that would doubtless be regularly advanced by lovers of power. In a totally unfree and unjust country, the comparative institutions political philosopher might drop philosophy altogether and become a real revolutionary. His kind of philosophy stops where direct and coercive use of power to impose a new pattern begins, but in many countries one sees little hope for improvement through philosophy. Such improvement requires at least some conditions of liberty.

In the middling condition of the United States and Western Europe, the comparative institutions political philosopher will find much need for his negative role. There are plenty of utopian and constructionist schemes to be attacked. But he will also find the positive role of providing a normative framework within which discussion and negotiation may help to move the society toward freer and more just conditions. Given the circumstances we presently face because of deficit financing of massive government transfers, Buchanan is surely right when he calls for the kind of fundamental consideration characteristic of constitutional reform. Such undertakings require a normative framework in order to bring to bear on human action the information gained from social science.

A political philosophy of comparative institutions is particulary well suited for those of us who share an overriding devotion to individual liberty and may help move that concern onto the public agenda of our time. Too often we are ignored both politically and in the moral views of our fellow citizens, even though the *facts* seem clearly on our side. I think the comparative institutions approach can provide the framework to make better use of those facts.

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Democracy, Interest Groups, and the Price of Votes

Gary M. Anderson and Robert D. Tollison

I. Introduction

The chief contribution of economics toward improving understanding of the way the world works is probably the theory of price. This theory has proven to be a robust tool for explaining how human behavior responds to changes in constraints facing individuals. Price theory may not be the most glamorous or technically demanding body of theory in economics, but it is likely the most fundamental. Economists may differ significantly in the composition of their intellectual capital stock, but all economists by definition have a basic understanding of the role of prices in economic affairs.

One of the most important recent extensions of basic price theory has been the development of the economic analysis of politics. The modern economics of politics is founded on the assumption that political actors are rational, self-interested maximizers, who respond to relative prices of resources and outputs—albeit often prices that are implicit and not publicly known—in the same way that private decisionmakers do in ordinary market exchange.

But curiously, the economics of politics has neglected a resource that is of vital importance for understanding political decisionmaking and policy determination and that (at least in the modern setting) is *unpriced*—the vote. Although economists have devoted a good deal of attention to the process of voting, there has been little effort devoted to explaining why votes are unpriced, or what the implications of this absence of market pricing are for political outcomes. The

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same economists who deliver eloquent lectures about the economic consequences of the absence of competitively determined prices in the case of ordinary resources tend to pass over the unpriced resource of votes in silence.

Our purpose here is twofold: first, to explain why the consequences of unpriced votes should be analogous to the failure of markets to price other resources efficiently; and second, to consider the historical world prior to the relatively recent innovation of the secret ballot from the standpoint of price theory. We examine the possible effects that the legal elimination of markets for votes may have had on the growth of government in the West and offer an interest-group explanation for the changes in voting rules.

The paper is divided into five sections. Section II considers the problem of votes as unpriced resources from the perspective of both the majority-rule/majority-cycling literature and the interest-group theory of government. Section III examines the history of open vote trading in Great Britain and the United States prior to the 20th century and discusses the economic implications of market prices for votes. Section IV outlines the course of legal changes—most important, the secret ballot—that eliminated the efficient pricing of votes. We offer an interest-group explanation for these events and suggest possible implications of these changes in terms of the modern growth of government. Finally, Section V summarizes and concludes the preceding argument.

II. Voting as a Problem in Nonprice Resource Allocation

In recent years two schools of thought, each designed to explain phenomena associated with the growth of government, have developed within the field of public choice. One concentrates on the theory of majority rule and its implications for the instability associated with democratic decisionmaking, and the other proposes an interest-group theory of government.

The former has largely grown from the work of Downs (1957), Black (1958), and Buchanan and Tullock (1962). The main focus of this literature has been the logical characteristics of majority-rule institutions. Considerable attention has been devoted to the various instabilities likely to emerge from such institutions, most notably the tendency for cycling of outcomes even when stable preferences of voters are assumed. Several writers have argued that this majority cycling results in less stable government policies over time. Some writers have also argued that this supposed logical inconsistency and

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consequent instability in democratic outcomes play an important role in explaining the rapid rates of government growth in 20th-century Western democracies.

As a rule, the majority-rule/majority-cycling theorists have avoided drawing any implications concerning the growth of government from their own work. Several writers have gone further, however, arguing that the tendency of majority-rule regimes to exhibit cycling has played a role in the rapid growth of government as a percentage of GNP in 20th-century Western democracies. Aranson and Ordeshook (1981) hypothesize that government may grow in a democracy due to "perceptual thresholds" among voters concerning the costs and benefits of privately consumed, publicly provided programs. In other words, successive unstable majority coalitions of voters will support programs that benefit themselves at the expense of others, and costs will be consistently misperceived as lower then they actually are, thereby allowing government to grow by accretion. Shepsle and Weingast (1984) argue that legislative institutions adjust to the tendency of majority-rule regimes to produce unstable outcomes by acting as "gatekeepers," which in recent decades have tended to control the agenda presented to voters. They emphasize the importance of legislative arrangements such as the proliferation of monopoly committees and subcommittees in Congress, each acting to protect distinct constituency interests, in causing the increasing rate of government growth. Brennan and Buchanan (1980, p. 23) argue that majority-rule institutions provide inefficient constraints against the expansion of political power.

Proponents of the interest-group theory of government argue that legislatures act as brokers, marketing wealth transfers to competing interest groups (McCormick and Tollison 1981). This theory differs radically from the majority-cycling approach in that voting is treated as a secondary characteristic of the political marketplace at best, and the competition of organized interest groups for rents derived from coercive governmental wealth transfers is seen as the primary determinant of political outcomes in a democracy. Some writers who operate within this paradigm (e.g., Kau and Rubin 1982; Peltzman 1984) grant the voting process a marginal role in determining political outcomes. Votes are treated as inputs in the political wealth-transfer process, analogous to natural resources in the production of ordinary goods and services. Interest groups must secure votes in order to implement the policies that benefit them. However, the expressed preferences of voters may play an additional, marginal role in determining policy.

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Unlike majority-cycling theorists, interest-group theorists have shown great interest in the effects of interest-group rent seeking on government growth. But different writers predict different effects. Some (e.g., Demsetz 1979; Olson 1982; Holcombe 1984) have argued that growth in the number of interest groups seeking transfers of wealth through the political process tends to cause government to grow. Others (e.g., Becker 1983; Tullock 1980, 1986; Anderson and Tollison 1985) have argued that because interest groups engage in both rent seeking and rent protection (i.e., protecting themselves from having their wealth taken away), the outcome of interest-group competition in the political process could increase, decrease, or have no effect on the net level of government, however measured (e.g., spending, regulation, and so on). In short, the interest-group theory does not necessarily predict government growth over time.

Both theories have one important assumption in common—they treat votes as unpriced resources. Such an assumption is reasonable in a modern context, where votes are unpriced resources because of strict laws against bribery of voters and, more important, the near-universal usage of the secret ballot. Because buyers of votes cannot monitor compliance or lack thereof, cheating by sellers can be neither detected nor sanctioned. Secret ballots make contracts between the buyers and sellers of votes unenforceable. Such contractual unenforceability tends, even in the absence of legal barriers against bribery of voters, to impose transactions costs on such exchange that are high enough to impede the operation of such markets.

The secret ballot is a *necessary* condition for the existence of majority-cycling phenomena in the context of large numbers of voters. In the absence of a secret ballot, enforceable contracts between voters and vote-buyers are feasible. Obviously, other factors also influence the efficiency of such a market, such as the presence and degree of enforcement of laws against bribery, legal penalties, and the like, but secret ballots will effectively prevent the emergence of market exchange in votes in the first place. Consider what would result from the enforceability of contracts between voters and vote buyers. Voters would act as the paid agents of interest-group principals, and would vote not to express their own preferences in terms of political outcomes but the preferences of those principals. Such outcomes would therefore represent equilibrium solutions in the market for wealth transfers to interest groups. Given that such equilibria would probably be fairly stable over time, political outcomes would tend to be stable as well. In any event, political outcomes would tend to be no less stable than the interest-group market equilibria of which they were the expression. In short, the question, "Why

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so much stability?" (in political democracy) becomes as irrelevant when markets for votes are permitted to function as a similar question would be in the case of the market for shoes or soft drinks. The problems associated with democratic instability enter only when voters are not contractually bound in their voting behavior. The majority of voters may choose A on Monday, B on Tuesday, and D on Wednesday, because they are completely unconstrained by contractual obligations in their voting behavior.

Of course, for a market for votes to emerge it is first necessary that there be only a single voting round for candidates and that the elected offices have fixed terms; otherwise, the expected return to potential buyers of votes would be zero. This is another way of saying that for exchange to occur, the object of exchange must be a scarce resource. The majority-cycling literature often employs elaborate thought-experiments in which the electoral process is not truncated (i.e., there is no limit on voting rounds), and in such situations a market for votes is impossible. But in the real world of democratic decision making, the situation is very different. Typically, there is only one voting round (election), and successful candidates serve fixed terms of office. Since votes are therefore scarce, vote markets are, in principle, feasible.

The possibility of a free market in votes has been analyzed previously but has generally been judged to be either inefficient or infeasible. Buchanan and Tullock (1962, p. 270 ff.) regard the possibility of free exchange of votes in a democracy as feasible but argue that such a market would tend to generate severe external costs and would therefore be inefficient. They argue that free exchange of votes under conditions of majority rule would increase the ability of majority coalitions to exploit minorities and that rational individuals would agree at the "consitutional" stage to prohibit such markets because they would tend to increase the level of redistributive activity and make society worse off in the long run. Although Buchanan and Tullock (1962, p. 272) admit that, assuming perfect markets, the ability of interest groups to exploit minorities with purchased majorities would disappear (because potential victims would match the investment in vote purchases of potential exploiters), they claim that in the real world certain minority groups (e.g., the poor) are more likely to face differentially higher transactions costs in vote markets than others (e.g., the rich) and to become the victims of income redistribution as a result.

The problem with this argument is that it is not limited to vote exchange as such, but is applied more generally to government by majority rule. External costs are the result of a system that allows coercive wealth transfers (by definition, non-Pareto optimal), regard-

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less of vote-transfer arrangements. The only relevant question is the relative magnitude of coercive transfers likely to result from a majority-rule system with and without free vote exchange, respectively. We cannot predict whether wealth transfers in general will be larger, smaller, or the same under either alternative regime. If the potential beneficiaries of wealth transfers face higher transactions costs than the potential losers in a vote market, transfers might increase, and vice versa. This becomes an empirical question. If we assume that rent-seeking and rent-avoiding interests in vote markets face similar transactions costs, and accept the argument that the randomness introduced into the electoral process by unpriced votes introduces a positive bias in the growth of government, free markets in votes might operate to constrain the magnitude of wealth transfers, *ceteris paribus*.

Coleman (1986) considers the theoretical problems associated with free exchange of votes and concludes that votes are not ordinary goods, implying that free markets for votes would be infeasible. Specifically, he claims that there are two critical differences between votes and other goods that greatly hamper the prospects for market exchange: first, votes are not alienable by voters (p. 171); and second, votes (unlike other goods) cannot be conserved—they are either used in the election or lost forever (p. 173). But the nonalienability of votes is simply a reflection of particular institutional arrangements; the vote could be separated from the owner if allowed by law. In fact, corporate shareholders commonly sell voting rights separately from actual shares. Nonalienability is irrelevant anyway; labor markets function efficiently even though an individual's labor is not alienable. The second objection concerning the fungibility of votes is also irrelevant. Tickets to specific sporting events, plays, and other performances also command zero price the next day, yet efficient markets for these goods exist. Of course, the nonalienability of votes from voters combined with the fungibility of votes together imply that a market for votes may be subject to relatively high transactions costs. A predictable transaction cost-minimizing solution would be the use of long-term contracts for voting, analogous to labor contracts. Voters would tend to sell their voting services over several elections rather than just one. If votes are as fungible as tickets to specific sporting events, we would expect something similar to season tickets to be a common contractual option.

There are other implications of the absence of market prices for votes. The problems discussed in the literature under the rubrics of "the paradox of voting" and "rational ignorance" become significant only when votes are unpriced. Given an efficient market for votes, there is no paradox of voting any more than there is a paradox of

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employment or of groceries. Individuals will vote in fulfillment of contracts which pay them such that price equals marginal cost. Rational ignorance becomes irrelevant because the preferences of the voter become irrelevant. Only the preferences of the vote-purchaser are important, and this individual or group, being a residual claimant, has incentives to acquire information about public policy questions efficiently. If voters choose instead to retain their vote for their own use, they will do so only if the marginal benefit they expect to receive from the exercise of their franchise exceeds the marginal cost (price forgone).[1] Both the paradox of voting (i.e., why voters bother to vote at all) and rational ignorance phenomena are the result of the absence of an efficient market for votes. The old adage seems to apply: you get what you pay for when votes are "free."

While the majority-rule literature depends on the assumption of unpriced votes, such an assumption is difficult to reconcile with the interest-group theory. If efficient markets for votes do not exist, interest groups cannot determine the outcome of the electoral process and can therefore have only a marginal influence over policy formation, *ceteris parabus*. Of course, because votes have no market price, the electoral choice of a voter is costless. Voters therefore have at best only a weak incentive to invest time and resources in becoming informed about public policies and issues, and are relatively manipulatable by agenda-setting politicians and interest groups. Also, markets may emerge elsewhere in the process; for example, vote buying may be replaced by corruption whereby fraudulent results are marketed to interest groups. Such fraud is reportedly endemic in many Third World "democracies," even though voting takes place in secret and open bribery of voters is illegal.

[1]It might be objected that, given that a vote will represent a bundle of different things—for example, the voter's ability to effect, at the margin, many different kinds of political decisions about various matters that may concern him—an efficient market for votes could not emerge because votes in general would not have determinate prices. One individual will perceive his vote as worth a great deal, while another will regard his as virtually valueless. Buyers and sellers in general would be unable to agree on a mutually acceptable price, and exchange would occur only sporadically, if at all. This objection, however, carries little weight. First, a similar argument could be made about many other goods that are routinely traded at determinate prices across ordinary markets. A car also represents a bundle of many different goods, covering an enormous range of possible opportunities that different individuals are likely to perceive differently. Votes—like money—can be analyzed as an ordinary good, whatever its unique attributes, which are not strictly relevant to the economics of price determination. Second, and perhaps more to the point, we know that the above objection is empirically irrelevant. Well-documented studies have shown that, historically, votes were routinely bought and sold across markets. In other words, it must be *possible* because we know it *happened.*

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The problem facing the interest-group theory is that it can offer an empirically rich economic explanation for most features of the political process except voting. This has caused some critics (e.g., Kau and Rubin 1982) to argue that interest-group theory neglects the significant role that ideology supposedly plays in determining democratic outcomes. Those with strong ideological preferences face a low or negligible opportunity cost of casting their unpriced votes in a manner consistent with their own personal beliefs. Interest-group theorists are, of course, aware of this problem.[2] Some have attempted to incorporate voting into their models, with varying degrees of success, given that under modern conditions "the market for votes" is at best a metaphor. But otherwise, the problem of the vote as an unpriced resource and the implications of this fact for the interest-group theory of government have been largely overlooked.

As we have seen, a necessary prerequisite for the existence of an efficient market for votes to emerge is the enforceability of contracts resulting from nonsecret voting. There are historical examples of political democracy in which votes were priced openly and exchanged. We examine two of the most interesting and best-studied cases: Great Britain prior to 1873 and the United States prior to 1890.

III. The Economics of Ballots and Bribes

There is a tendency in the modern literature simply to assume that the secret ballot is somehow a necessary feature of electoral systems, one that has always been part of the democratic process. Of course, this is untrue. The secret ballot is a relatively recent innovation in Western democracies.

In Great Britain, the secret ballot was established with the Ballot Act of 1872. Before its passage, however, votes were openly bought and sold, either through explicit bribes or implicit payments of various sorts. Williams (1970, p. 498) explains that in 18th-century England, even the "forty-shilling freeholders," who were legally per-

[2]Becker (1983) argues that voters are so readily manipulatable by competing interest groups that the effects of their independently expressed preferences are relatively trivial and that therefore democratic decision making tends to approximate a stable interest-group equilibrium. Demsetz (1979) notes that votes are unpriced resources and argues that votes are thus both a major source of the comparative inefficiency of political markets and a factor in explaining the apparent domination of the decision-making process by organized interest groups. Peltzman (1984) argues that voters' individual ideological preferences, combined with their perception of the diffuse benefits likely to flow to their communities (and possibly to themselves), are likely to make voters a significant additional "interest group."

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mitted to exercise the franchise, were generally acting as the agents of others in their voting:

> The elections were arranged by the nobility and gentry meeting in one or other of the country houses or in an inn in the local market town. Once their wishes became known, the forty-shilling freeholders knew how to cast their votes—such were the pressures that the landed classes could exert, as landlords of farmers, as employers of labour, and as customers of tradesmen, on voters not yet protected by the secret ballot.[3]

According to Namier (1956, pp. 65, 68), voting in 18th-century Great Britain tended to be the electoral expression of the preferences of the voter's landlord or employer:

> [Because] the voting was open and recorded in poll-books, people in dependent positions could seldom exercise a free choice; and as the agricultural interest was dominant in the counties, the result of county elections was determined as a rule by the big landowners—the territorial magnates and country gentlemen. . . . Neither in counties nor in boroughs was the least attempt made to hide or disguise the methods by which votes were secured. . . . It was taken for granted that the tenants would vote as instructed by their landlord or his agent, and the methods employed were so common that they were seldom named.

In fact, in prereform Great Britain parliamentary seats were mostly uncontested in elections. Rather than attempting to buy sufficient votes to defeat the incumbent, it was more common for those with parliamentary ambitions to purchase seats outright from the patrons who controlled them through their influence over their enfranchised renters. According to Namier (1956, p. 166), in 1761 the ordinary price of safe seats was about £1,500, although in cases where additional advantages were to be expected, the price could range as high as £2,000. Namier (p. 77) explains that bribery was common even in those parliamentary boroughs with the largest electorates, although the price per vote usually was lower: "drink and a few guineas for each voter [took] the place of substantial payments and petty offices for a local oligarchy."[4] The amount spent by competing interest groups

[3]If renters paid their rents partly in cash and partly by committing their votes to their landlords' use, the institution of the secret ballot—by significantly lowering the effective market price of their votes—would have tended to increase the pecuniary component of rents demanded by landlords. Such additional freedom was probably not welfare enhancing for renters and, given that it restricted their choice set, may have been welfare reducing.

[4]In 1780 William Wilberforce (later one of the leaders of the English abolitionist movement) decided to enter the House of Commons. The election cost him £9,000 because he paid two guineas per vote (Mannix and Cowley 1962, p. 179).

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in bidding for votes sometimes was substantial. For example, in the Oxfordshire parliamentary election of 1754, the Tory party spent about £4,000 to oust the Whig incumbents (Plumb 1963, p. 85). Plumb (p. 37) also notes that total expenses for both sides in a contest for seats in a large county could total £100,000 or more.

Even after the Reform Bill of 1832 (which extended the franchise to owners of property worth as little as £10), bribery remained a common practice, although prices for votes tended to vary across boroughs. For example, according to Spearman (1957, p. 93), in 1841 the price of votes in the large towns of Leicester and York ranged from £1 to £2, whereas in the same year in the smaller town of Ipswich, £15 to £20 were paid per vote. The more or less open buying and selling of votes continued to be standard practice throughout the 19th century prior to the passage of the Ballot Act.

A similar situation existed in the United States. Ostrogorski (1964, p. 170) claims that while prior to the Civil War electoral bribery was widespread "only in three or four large cities," following the war, bribery of voters became the rule rather than the exception. He attributes this development to the rapid growth of cities, which tended to lower transactions costs associated with vote buying. Before the introduction of the secret ballot, agents of political parties often set up booths at polling places and offered cash for votes. This practice was apparently widespread in New York (Bryce 1910, p. 148). As he summarizes, "In the absence of secrecy, [the] voter could be followed by watchful eyes from the moment when he received the party ticket from the party distributor till he dropped it into the box" (p. 147). Wendt and Kogan (1974) offer numerous examples of the bribery of voters in Chicago in the period prior to the enactment of the secret ballot in Illinois. For example, in the 1896 election for mayor in the 19th Ward, the ward boss of the Democratic party reputedly paid $10,000 for votes (Wendt and Kogan 1974, p. 149).

In the United States the secret ballot was introduced between 1888 and 1910 by state laws requiring use of "Australian ballots." The Australian ballot required that ballots be printed with the names of all candidates and that voting be conducted in strict secrecy. In Great Britain another major structural change in the electoral process occurred over the course of the 19th century—the extension of the franchise. Before the 1832 Reform Bill, only about 1 in 12 adult Britons had the vote: after its passage about 1 in 7 did. The 1867 Reform Bill increased this proportion to about 2 out of 3, and, finally, the 1884 Reform bill provided for universal manhood franchise (Rabushka 1985, pp. 99–108). Many writers have maintained that this rapid expansion of the franchise played an important role in the

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growth of government in late 19th-century Great Britain, as the working classes increasingly voted themselves transfers. The introduction of the secret ballot in 1873 is usually viewed as having played a significant but relatively minor role in this process of franchise expansion.

The expansion of the franchise surely played an important role in the expansion of government activities in 19th-century Great Britain, but in our estimation the role of the secret ballot in this process has been underestimated. The simple expansion of the franchise need not have had any direct effect on the ability of interest groups to dominate the process through the purchase of votes. Franchise extension implied that in order to win an election an interest group had to purchase more votes but not necessarily pay more in bribes. A "quantity theory of votes" would have tended to operate, analogous to the quantity theory of money: an increase in the quantity of votes in circulation reduces the value of each individual vote, *ceteris paribus*. The expansion of the franchise may have tended to benefit certain interest groups (e.g., manufacturers' associations in urban areas) at the expense of others (e.g., rural landowners) due to the presence of positive and differential transactions costs in the market for votes. However, the expansion of the franchise per se probably had only a minor effect on the total investment necessary to buy enough votes to ensure a particular electoral outcome. We shall return to this issue below.

IV. An Economic Theory of the Origin of the Secret Ballot and Its Effects

If the competition among interest groups determined the allocation of votes before the introduction of the secret ballot, how could the secret ballot itself have been introduced, unless some interest group expected to benefit as a result of its passage? But what interest group could have possibly benefited from the legal prohibition of the market for votes? These difficulties are sufficiently serious to render the conventional wisdom regarding the introduction of the secret ballot—that is, that it resulted from a reformist zeal to cleanse the electoral process of unseemly corruption—relatively attractive by default. However, there may be an economic explanation of these changes that does not lean heavily on the slender reed of reformist zeal. The legislation introducing the secret ballot can be explained as an example of Director's Law at work.

Director's Law states that public expenditures are made for the primary benefit of the middle class and are financed with taxes borne

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largely by the rich and the poor (Stigler 1970, p. 1). Certainly, the middle-income class stood to gain from the introduction of the secret ballot. The open ballot allowed efficient vote markets to develop, which, in turn, permitted the rich to invest in rent protection by purchasing large blocs of votes from the poor. The minority of the wealthy was less vulnerable to the depredations of the majority of the nonwealthy because the wealthy could buy a majority as needed.

Consider the problem in the context of the universal manhood franchise. Both the wealthy and the middle class are likely to have high reservation prices associated with their votes, because both groups have significant economic assets to protect from political confiscation. Moreover, they will often be members of organized interest groups that function as voting blocs designed to benefit their members economically. But the relatively poor—in the late 19th century, the majority of eligible voters—will have low reservation prices associated with their votes. They have few assets to protect and relatively few opportunities to benefit from entry restrictions or other political rent opportunities. Also, the poor have traditionally tended to be relatively disorganized, probably in part because they have few assets and therefore few reasons to organize.

Because the poor tend to face extremely high costs of organization, it may have been technically possible, although economically inefficient, to organize as a bloc of voters in order to secure net wealth transfers to themselves as a group. From the standpoint of the individual poor voter, a more attractive alternative than tilting at the windmills of redistribution would have been to sell his vote to the highest bidder. In other words, the poor in their voting, as in other domains of behavior, are less likely to act as independent entrepreneurs. Instead, they sell their voting services to an employer who pays them a wage.[5]

Who were the highest bidders for the votes of the poor? There is clear evidence in the case of Great Britain, and some evidence in the case of the United States, that the voting services of the poor were largely purchased by the relatively wealthy. In 18th- and 19th-century Great Britain, it is well documented that entire boroughs of voters were essentially the employees of large local landowners and that the rich were the source of most of the vote bribery. In the United States, extremely wealthy groups controlled the big-city

[5]This does not imply that poor individuals necessarily entered into long-term voting contracts with vote purchaser—although such arrangements were common in Britain before the secret ballot—but only that in voting they were more likely to be acting as agents of someone else, whether for the election in question or a longer term.

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machines and purchased a disproportionate share of the votes of the poor. Although the terms "poor"and "rich" are vague, it seems evident that the votes of those in the lowest 10 percent of the income distribution were largely being purchased by the dollars/pounds sterling of those in the upper 10 percent. Labor unions, guilds, and other organizations that presumably represented the economic interest of those in the middle range of the income distribution were evidently not major participants in the competitive bidding for votes.

The rich, by definition, had the most to lose. But why would the interest of the relatively rich in protecting their wealth from confiscation through the political process imply that they would be willing to bid higher prices for the voting services of the poor than those the nonrich would offer? One must keep in mind the structural characteristics of government in the 19th century in both Great Britain and the United States. While there presumably was no less interest in rent-seeking activity than there is today, the political structure of the modern welfare state that facilitates the process of wealth transfers was not yet in place. In particular, there was no established system of government spending programs and its attendant bureaucracy that would lower the political costs associated with achieving and implementing coercive transfers of wealth to interest groups. For example, there was no Interstate Commerce Commission to administer entry barriers in transportation so that restriction rents flowed to interest groups that had bid highest in the legislature; there was no Agriculture Department to erect and maintain elaborate coercive cartel agreements and price supports to farm interest groups; and there was no Internal Revenue Service to administer a costly system of progressive income taxation. As a result, agreements between legislatures and interest groups regarding wealth transfers were costly to implement and maintain. There was no well-established system for ensuring that wealth transfers from government went to the same people who bought them. Contracts between demanders and suppliers of legislative wealth transfers were difficult and costly to enforce. Property owners (i.e., potential wealth transferees) did not face an analogous problem.[6]

Consequently, the creators of wealth held a comparative advantage over the potential redistributors of wealth in the political marketplace. Crudely put, a potential transfer that I expect will cost me $1

[6]Growth of the modern transfer-state bureaucracy as an independent interest group has also lowered the relative costs associated with expansion of redistributive programs. Both potential beneficiaries and bureaucrats who expect to administer the proposed programs tend to form effective coalitions, which reduce the cost of such programs to rent-seeking interest groups.

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would be worth investing up to $1 to prevent. If, however, the high transactions costs associated with politically determined wealth transfers meant that the potential recipient could only expect to receive, say, 90 cents on the dollar I lose (and therefore would be willing to spend no more than 90 cents on bidding for votes to achieve the transfer), the equilibrium outcome implies a victory for the opponents of redistribution. It is better to sell your vote for a dollar than for 90 cents. Of course, few wealthy owners invested more than a small fraction of their total wealth in rent-protecting vote purchases, but the opportunity to do so helped shield them from the kind of majoritarian wealth redistribution that they might otherwise have expected in the absence of open vote markets, given the relatively high concentration of wealth among relatively few voters.[7]

After the passage of the secret ballot in 1872 in Great Britain, the percentage of Commons seats held by landed interests dropped like a rock.[8] Other factors may also have contributed to this development, but it is consistent with our hypothesis.[9]

[7]We recognize that, given perfect markets, the rich would have no comparative advantage in the competition for votes. Assuming zero transactions costs, those in the middle class would be willing to pay as much as the rich for votes, and the poor would be at no relative disadvantage purchasing the votes of other poor. However, the structure of transactions and information costs in actual historical vote markets appears on net to have benefited the potential victims and not the potential beneficiaries of government wealth transfers.

[8]According to Bentley (1958, pp. 195–96), 47.3 percent of Conservative MPs in 1868 could be classified as representatives of landed interests, while 30.9 percent represented industrial, commercial, and financial interests. By 1900, these percentages had changed to 21.2 percent and 50.4 percent, respectively (throughout the century the liberal party had overwhelmingly represented the latter interest). Admittedly, the expansion of the franchise probably accounted for some of this shift; in the pre-Reform Parliament of 1832, the landed-commercial percentages in the Conservative side of Commons were 58.3 percent and 22.3 percent, respectively, indicating a significant drop between 1832 and 1868 in favor of the latter group. But it is plausible to propose the secret ballot as an important factor.

[9]Although William Gladstone and John Stuart Mill expressed opposition to the concept of the secret ballot in the first half of the 19th century, John Bright—the classical liberal and leader in the fight to repeal the Corn Laws in the early 1840s—was the chief proponent of the secret ballot within the Liberal Cabinet, and played an important role in the passage of the Ballot Act. Spearman (1957, pp. 124–25) explains:

> The high seriousness of Gladstone and Mill [about the duty of a citizen to be publicly accountable for his vote] was not shared by the new generation; in the boroughs the majority of men were now voters, and the new Liberals were more impressed by the danger of losing elections through bribery and intimidation by their opponents than by the danger of tempting the elector to make a frivolous or selfish [?] choice.

In other words, at least some advocates of the secret ballot did so because they at least in part sought a temporary political advantage over the (primarily Tory) landed interests.

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Advocates of the secret ballot may also have intended to disfranchise recent immigrants who were technically eligible to vote.[10] Bryce, (1910, p. 49) notes that the introduction of the secret ballot in the United States effectively prevented large numbers of "the most ignorant class of voters," recent immigrants, from exercising the franchise. The Australian ballot system required voters to read the ballot in order to vote, and many recent immigrants could not read English. Between 1880 and 1914 a variety of immigration barriers were erected against specific groups of potential immigrants, especially the Chinese (Sowell 1981). Recent immigrants, even if citizens themselves, often had family members left behind who desired to immigrate, and would therefore have tended to oppose immigration barriers. The introduction of the Australian ballot may have functioned as a kind of parliamentary strategem by which those interest groups seeking entry barriers against immigrants gained a (temporary) advantage over the likely opponents of such restrictions.[11]

If the introduction of the secret ballot played an important role in increasing the tendency of democratic governments to grow, an apparent anomaly in the respective economic histories of Great Britain and the United States becomes understandable. Basically, the modern expansion of both the size and scope of government seems to have begun earlier in Great Britain than in the United States. In the 1880s, the long period of decline in government expenditures as a percentage of national income (27.1 percent in 1811 to 7.4 percent in 1871) was reversed.[12] By the first decade of the 20th century, the

[10]The secret ballot may have, in effect, functioned in a manner similar to literacy requirements and other restrictions on the franchise in southern states under "Jim Crow" that reduced the number of black voters quite effectively. On these restrictions, see Woodward (1971, pp. 321–49). The Australian ballot might best be viewed as an integral part of the Jim Crow system in the South.

[11]The introduction of the secret ballot would also have tended to reduce the economic returns to immigrants from entering the country and becoming citizens. Immigrants who became citizens acquired a valuable and marketable asset—their votes. The capital value of votes was drastically reduced after the introduction of the secret ballot. Citizenship in this sense became less valuable. While the economic opportunities available to immigrants would otherwise have been unaffected, all of these prospects were by their very nature uncertain. A significant number of risk-averse immigrants may have perceived the expected returns from the sale of their votes as a significant factor in their decision to undertake the risky enterprise of emigration. This reduction in the capital value of the vote may help to explain the passage of the British Ballot Act. Immigrants to Great Britain in the late 19th century came primarily from Ireland, and the secret ballot would have tended to reduce the incentive to move to Great Britain. Hence, simply by lowering the marketability of the recent immigrant's vote, the secret ballot would have acted as an entry barrier against competing foreign labor.

[12]Calculated from data in Mitchell and Deane (1962, pp. 366, 389–91, and 396–99). Also see Peacock and Wiseman (1961).

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legislation that established the basis for Great Britain's emerging welfare state was in place.[13] But during the same period, U.S. government expenditures as a percentage of GNP continued to decline, continuing the pre–Civil War trend (see *Historical Statistics of the United States* 1975). This decline continued until World War I. Over the same period, while the scope of federal economic regulation increased significantly, no redistributive programs were instituted similar to those in Great Britain. The growth in American government really began during and after World War I.

The secret ballot was introduced by Parliament in Great Britain in 1872. In the United States the first Australian ballot bill was introduced by the Michigan state legislature in 1885, and Massachusetts passed the first ballot bill in 1888. By 1910, 46 of the 48 states had some sort of secret ballot by law (Bryce 1910, p. 148). If the instability inherent in electoral outcomes, given the assumption of a secret ballot, tends to cause the rate of government growth to increase *ceteris paribus*, the timing of the introduction of the secret ballot in the British and American cases may help to explain the different growth patterns in those two countries before and after the electoral innovation.

V. Conclusion

The argument presented here can be simply summarized. While the effects of prohibiting efficient market pricing for scarce resources are taken for granted by many economists, they have failed to extend their analysis to the process of voting. Because of laws preventing the exchange of votes in markets, votes represent an unpriced resource. While various laws against bribery of voters function both to reduce the quantity of votes supplied and to increase the price, the institution that acts effectively to prohibit the emergence of a competitive vote market altogether is the secret ballot, which prevents enforceable contracts between buyers and sellers. Voters consequently have only a negligible incentive to allocate their votes efficiently. The various paradoxes of voting and the instability phenomena associated with democratic decision making result from this fact.

If votes can be freely traded across markets, voters will act purely as agents of interest groups who bid competitively for these scarce resources. The fact that votes are vested in specific individuals will tend to raise transactions costs in such a vote market by comparison with a system in which votes are fully alienable (i.e., X can buy Y's

[13]See Schweinitz (1943, p. 202) for a detailed summary of these developments.

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vote outright rather than having to hire Y to vote as X prefers). Until recently, votes were bought and sold across markets. Under such circumstances, the various theorems about the inherent instability of democratic decision making become irrelevant. Democratic outcomes become fully equivalent to interest-group equilibria in political markets.

If the modern theories that link the instabilities of democratic decision making to the growth in government—which we have argued are irrelevant except in the context of the secret ballot—are correct, the introduction in both Great Britain and the United States of the secret ballot may help to explain the transition in both countries from a gradual but steady *decline* in the size and scope of government during the 19th century to the consistent and increasingly rapid growth characteristic of the 20th century. This possible relationship seems deserving of future empirical research.

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Visual Artists' Rights Act of 1987: A Case of Misguided Legislation

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Introduction

Since the middle of the 1970s, what Dempsey (1935) would have called a vulgarization of the concept of just price has become popular in artistic circles in the United States. Indeed, this just price variation has already taken the form of a statute which has been in effect in California since 1976 and which more recently as been proposed as federal law by Senator Edward Kennedy and Representative Edward Markey. The Kennedy-Markey bill amends the copyright law to secure the rights of authors of pictorial, graphic, or sculptural works (i.e., artists) to prevent the distortion, mutilation, or other alteration of such works and to provide for resale royalties for the lifetime of the artist and up to 50 years after his or her death. The right to receive this royalty may not be waived.

While the California statute and the proposed legislation are different in design and economic impact, both imply to an economist the by now unusual idea that in an unconstrained transaction there exists objective value apart from the value in the minds of the buyer and seller. To an attorney, on the other hand, the laws also imply that like children and mental defectives, artists are not competent to alienate property.

The basic premise of both laws is the concept of *droit de suite*, which is usually translated as "right to art proceeds." This idea posits that artists have a right to a portion of the resale value of their art since, for various loosely defined reasons, the artist is unlikely to

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obtain the "true" value of the art at the time the art is originally sold. In both laws the term "art" refers to nonreproducible paintings (or graphics) and sculpture. Either for pragmatic reasons, or because they do not fit into what Price and Price (1972) have called the theology of *droit de suite*, art, as defined by these laws, does not include the work of architects.

As originally formulated, the California statute requires that a royalty of 5 percent of the resale price of a work of art be paid to the artist when the resale takes place within the boundaries of the state of California. The law contains a *de minimis* exemption for gross transactions of less than $1,000 and any gross resale which is less than the original purchase price.

The Kennedy-Markey proposal is analogous to a capital gains tax which requires that a 7 percent royalty be paid on any excess between the resale price and the purchase price. The major exception is for works whose gross resale price is less than $1,000 or 150 percent of the purchase price.

Both laws contain a provision that *prevents* an artist from entering into a contract with a purchaser whereby the artist waives the right to the resale royalty. This prohibition clearly violates the legal maxim that anyone may waive a right asserted in his or her behalf, and it thereby prevents the artist from selling, or alienating, his or her property. It should also be noted that the royalty in both cases is asymmetrical in that the artist is not required to pay the purchaser a refund should the resale price be lower than the price originally paid for the art. This asymmetry clearly reduces the potential gain to a purchaser of art without any offsetting reduction in potential loss.

Finally, it is worth noting that variations of both laws are presently in effect in several European countries. The California statute is akin to the law of France, while the Kennedy-Markey proposal is closer to the law of Italy (see our 1978 paper).

The proximate impetus for importing the European concept of *droit de suite* to the United States comes from the celebrated case of the conflict between investor Robert Scull and artist Robert Rauschenberg. Rauschenberg felt himself wronged by Scull's resale of his painting "Thaw." Scull had purchased Rauschenberg's painting directly from the artist in the 1950s for $800 and resold it at auction 20 years later for $85,000, a return somewhat lower than would have been obtained by an investment in IBM stock over the same time period (see Elsen 1977 and Hochfield 1976, 1977).

Regarding this dispute, one needs to realize two things. First, that the artist benefited by Scull's investent in that the profitable resale of "Thaw" enhanced the value of *all* of Rauschenberg's work, present

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and future. Second, that by focusing on one profitable work in a portfolio, one overestimates the return on the entire portfolio, since the vast majority of artwork decreases in value.

Rates of return on traded art are notoriously low, despite the occasional spectacular price for a Van Gogh, Picasso, or Warhol. Baumol (1986) examined resale prices of art works by the most famous painters of the world over a 300-year period and found an annual compounded rate of return of 0.55 percent in real terms with no adjustments for sales commissions, maintenance costs, or risks.

The Benchmark Sell or Invest Decision

Art may be purchased for investment reasons, for consumption reasons, or for a combination of the two. Since both the California and the Kennedy-Markey statutes are directed mainly at the investor, we will limit our analysis to this aspect of art purchasing; after all, it is profitable resale that sets the value for current and future works of an artist. More importantly for our purposes, one almost never sees in the literature that is favorable to *droit de suite* any mention of the fact that artists are perfectly free to invest in their own art. Monet, who lived his early life as an artist in the proverbial garret, was one such investor; Picasso was another. Let us consider the artist as a potential investor in his or her own art who faces a purchaser who is also interested in investing in the particular work of art. We will concentrate on a simple two-period model which is easily transformed into a multiperiod model involving several sales and resales.[1]

To avoid problems with expectations, let us assume that the artist and all potential purchasers are in agreement as to the resale value of the art one period from today, P_1. It is axiomatic that, of all potential purchasers, the individual with the lowest discount rate (the lowest need for present consumption) will offer the highest bid for the art. Let us call this discount rate r_*, which will be used to define the present value of the work of art to this prospective purchaser: $P_1/(1+r_*)$.

If we denote the discount rate of the artist as r_a, then the artist will prefer to sell the work of art whenever the present value of the art to the artist is less than the present value of the art to the potential purchaser. Thus, a sale will take place whenever

$$P_1/(1+r_*)>P_1/(1+r_a), \tag{1}$$

[1]No generality is lost by our concentration on a two-period model in that the results given below will simply be magnified in multiperiod exchange.

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which reduces to

$$r_a > r_*. \tag{2}$$

Equation (2) gives the classic result that the sale will take place if the artist has a greater present need for consumption than the buyer with the least present need for consumption among all prospective buyers. If by use of the term "starving artist" we mean a relatively high value for r_a, then at some future time the artist may retrospectively view the sale with regret when, perhaps because of increased wealth, the artist's need for present consumption falls. In our view this retrospective regret is the source of feelings of unfairness that give rise to *droit de suite*. Notice, however, that no notion of disproportionate "market power" on the part of the buyer is necessary for us to obtain this or any other result to follow. In fact, as McAfee and McMillan (1987) have recently pointed out, from the point of view of a standard English auction, the artist is in reality a monopolist with respect to any single item of nonreproducible art.

The California Statute

Assuming that the art appreciates beyond the *de minimis* point, the California statute levies a royalty of 5 percent upon the resale price of the work at the end of the holding period. If we denote this royalty as t, then the best offer that will be made today for the art by a prospective purchaser is

$$(1-t)P_1/(1+r_*), \tag{3}$$

where $t = 0.05$.

In addition to this offer, the artist will also receive the amount tP_1 (the royalty payment) at the end of the holding period, which will have a discounted worth today to the artist of $tP_1/(1+r_a)$. Now, a sale will take place whenever

$$(1-t)P_1/(1+r_*) + tP_1(1+r_a) > P_1/(1+r_a). \tag{4}$$

As before, the sale will occur whenever $r_a > r_*$; and when $t = 0$, equation (4) reduces to equation (1) as it should. Note also that when $t = 1$, the entire resale price is returned to the artist and that the leftmost term of equation (4) becomes zero, indicating that the artist will never be able to sell the art to a rational investor.

It is now quite easy to show the basic difficulty of the California statute. The artist will be better off with the statute whenever the left side of equation (4) is greater than the left side of equation (1).

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Upon substitution, one immediately finds that this inequality is possible only if

$$r_* > r_a, \tag{5}$$

which is in direct contradiction to equation (2). In short, given the discount rates, the artist will always be worse off with the statute than without it.

The common sense of this finding is simple. The royalty statute prevents the artist from selling the entire work of art, forcing the artist instead to retain a residual interest in it. If the return on this implicit investment is greater than or equal to the discount rate of the artist, then the artist will not be adversely affected by the forced investment. However, the greatest return that the artist can expect to receive from this investment is the discount rate of the purchaser, r_*, which is necessarily less than the discount rate of the artist, r_a. Thus, the artist who wishes to sell the entire work of art will always be adversely affected.

The Kennedy-Markey Statute

Again, let the resale price be P_1 and the purchase price P_0. The capital gain from the resale of the art is the difference between these two prices, $P_1 - P_0$. Then, subject to the *de minimis* provisions, and with the royalty rate $t = 0.07$ for the Kennedy-Markey proposal, the best offer that will be made for the art is

$$P_0 = \frac{P_1 - t(P_1 - P_0)}{1 + r_*} \tag{6}$$

so

$$P_0 = \frac{(1-t)P_1}{1 + r_* - t}.$$

The artist will also receive upon resale a royalty payment whose present value to the artist today is $t(P_1 - P_0)/(1 + r_a)$. Therefore, the sale will take place whenever

$$\frac{(1-t)P_1}{1 + r_* - t} + t(P_1 - P_0)/(1 + r_a) > P_1/(1 + r_a)$$

or

$$(1-r)P_1/(1 + r_* - t) + tr_*P_1/(1 + r_a)(1 + r_* - t) > P_1/(1 + r_a). \tag{7}$$

This expression reduces to $r_a(1 - t) > r_*(1 + t)$ which cannot hold unless $r_a > r_*$. Again, when $t = 0$, equation (7) reduces to equation (1); and

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again, when we ask when the left side of equation (7) will be greater than the left side of equation (1), we find that the same contradiction exists as before, namely, that $r_* > r_a$. Therefore, the Kennedy-Markey proposal exhibits the same basic problem as the California statute: it is not in the best interests of the artist.[2]

Who Benefits from Royalty Statutes?

The pressing question about art royalty statutes is why they are advocated at all since both economic theory and common sense predict that the offer price for new art will simply be reduced in a way which is disadvantageous to the artist when the rational buyer takes into account the resale royalty. There is only one class of art whose original sales price will not be reduced by the royalty legislation—art which was sold prior to the legislation. Therefore, the legislation will tend to benefit older more established artists at the expense of younger, less-established ones. The laws provide, in essence, a subsidy to established artists who have a viable resale market for their works, at the expense of unestablished artists.

Unfortunately, artists whose works are in this privileged class are rare indeed. According to the Art Dealers Association, there are only about 50 living artists who have a significant resale market for their work, and almost all art depreciates in value (see Hochfield 1976). Thus, these statutes will benefit only the selected few artists who need protection the least. In addition to established artists, there is a second group of "winners." The Kennedy-Markey bill provides for a federal registration system for "works of fine art." And to determine whether or not a specific work qualifies as art, a court may take into account the opinions of artists, art dealers, collectors of fine art, curators of art museums, restorers and conservators of fine art, and other persons involved with the creation, appreciation, history, or marketing of fine art—in short, the art establishment. Everyone in

[2]As indicated earlier, this analysis is based upon only one resale of the work of art. If the royalty applies for N years and the artwork is traded every τ years, the current price will be

$$P_0 = \left[\frac{(1-t)}{(1+r_*)^{\tau}-t}\right]^{N/\tau} P_N,$$

where P_N is the value of the work N years hence. This expression shows that the current price is discounted by the royalty rate $^{N}/_{\tau}$ times (i.e., each time the work is sold in the N year horizon). Note that P_0 increases when t is decreased (i.e., the larger the royalty, the more the current price is discounted) or when τ is increased. Thus, only by decreasing the art's visibility (e.g., through longer lags between auctions) can the deleterious effect of the royalty be mitigated and even then never completely.

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the art community wins but the struggling artist and the risk-taking investor.

Conclusion

The concept of royalties for fine art is derived from a false analogy with the royalties paid to writers and composers whose work is expandable through further production. Yet, fine art by definition is not expandable except by the artist himself. The analogy, therefore, fails.

The economic problems with royalties for fine art have been amply demonstrated by the market itself. A legal instrument which artists may use to contract for royalty payments has been widely available for some time (see the "Projansky Agreement" in Feldman, *et al.* 1986). Artists who are proponents of the statutes reviewed here claim that such agreements cannot be made to work without national legislation. What they really mean is that the agreement cannot be executed at prices which artists find favorable. Legislation will not change this fact because it is inherent in the process of negotiation for fine art.

Although a laudable attempt to help artists in general, the proposed legislation misfires. Because (1) the appreciation in value of art work is "taxed" but there is no relief from a decline in value, and (2) the expected benefits will accrue to only the few artists with a significant resale market for their works while all others will be hurt. Thus, the economic impact of the act is clear. Investment in the work of unknown artists will be dampened and only the few, well-established artists will benefit. This is surely an unintended result of legislation proposed to introduce "fairness" into the art market.

While profitable resale is rare, such resales already substantially benefit artists. Future works as well as those in inventory ("voluntary investment") appreciate in value *pari passu*. With profitable resales, artists such as Rauschenberg should rejoice when an art investor profits from taking risks in their works. "A rising tide lifts all boats" and a rising price for art helps all artists. Legislation is not needed to cause this to happen.

If the definition of property rights is extended to include a residual right in future resales, a right that cannot be waived according to the proposed legislation, artists are prevented from alienating their property—a clear violation of the legal maxim that anyone may waive a right asserted in his or her behalf.

The art royalty statutes are paternalistic, misguided attempts to help artists. They help the few who need help the least; they decrease

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the incentive for investment in works of art; they assume that artists are incompetent to alienate property; and they create a costly bureaucracy to manage a national registration system for art. The concept should be abandoned.

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Hard Coals Make Bad Law: Congressional Parochialism Versus National Defense

Robert Higgs

The U.S. national defense program is very expensive and notoriously plagued by waste, fraud, and mismanagement. Members of Congress, whose duty it is to oversee the program, often complain about it and take various actions ostensibly to repair its flaws. Unfortunately, as Rep. James Courter (R-N.J.) has said, "Congress is not the answer to waste. Congress is the problem." Economist Herbert Stein, a member of the Packard Commission, has observed that major defense problems "are compounded when the decisions move to Congress." The root of congressional misfeasance, says Stein, is that "hardly anyone [in Congress] feels a primary responsibility for the defense program as the safeguard of our national security. Too many are able to look upon the defense budget as a big pot of money from which they can serve their special interests."[1]

Analysts often dismiss this aspect of defense budget waste as "small potatoes." But is it? Assistant Defense Secretary Lawrence Korb recently estimated that the congressional pork barrel costs "at least $10 billion a year [for] things we don't want, things we don't need," but which are put in the budget "to protect vested interest." Richard Stubbing, a long-time defense specialist at the Office of Management and Budget, considers Korb's estimate probably too low.[2] The defense

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[1]Courter as quoted in Fossedal (1985); Stein (1986).

[2]Korb as quoted in Stubbing (1986, p. 101). Stubbing's own observation appears on the same page.

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pork barrel looks small only in relation to the gargantuan total defense budget. In any other perspective it looks like "real money."

After presenting some facts and arguments pertaining to Congress in general, I shall tell the story of a congressional boondoggle involving the use of anthracite coal. It is one of the many "small potatoes" measures embedded in the defense program. Viewed in isolation, it lacks earth-shattering importance. Yet it is instructive. Its elements, so visible and so utterly inexcusable from the standpoint of genuine concern for national security, show how and why in other, often more costly ways the members of Congress treat the defense program as a means to serve their own selfish, parochial, and wasteful ends.

Congress: Incentives, Structures, and Strategies

The first thing to notice about members of Congress is that they have a job. They have worked hard to get it and, with few exceptions, they want to keep it. Congress, as political scientists have shown, has become a career for many of its members. Because in modern times some 90 percent of members stand for reelection and of those about 90 percent are reelected, Congress consists mainly of people who have spent a long time in the job and who expect to spend many more years in it. Between 1969 and 1986, incumbents averaged about 11 years of service.[3] They may be interested in contributing to good public policy—no doubt some are so interested, always according to their own ideological predilections, of course—but reelection must be their proximate goal. To achieve their policy goals, they must remain in the job. As a former congressman wrote, "All members of Congress have a primary interest in getting re-elected. Some members have no other interest."[4]

Accordingly, they strive ceaselessly to gain the approval of a majority of those who will cast ballots in their districts at the next election. Representatives in particular are "always running." But senators, whose longer terms give them more breathing room, cannot afford to grow complacent, as their probability of reelection is substantially lower than that of House members: 75 percent versus 91 percent for elections between 1946 and 1984; 75 percent versus 98 percent in

[3]Davidson and Oleszek (1985, pp. 37–40); Fiorina (1977, pp. 39–40, 60, and passim); Mayhew (1974, pp. 5–6, 16, 49, and passim).

[4]Frank E. Smith (D-Miss.) as quoted in Mayhew (1974, p. 16). See also Rep. Carl Vinson's advice to a new congressman, as quoted in Reed (1984, p. 234). For a clever test of the influence of ideology on defense voting in the Senate, see Nelson and Silberberg (1987). On the question of self-interest versus ideology and most other matters discussed in this section, I am indebted to Lindsay (1987, 1988, and forthcoming).

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1986.[5] Incumbents need not worry much about conditions or opinions elsewhere in the nation or the world. Retention of the job turns on satisfying a majority of voters *in one's electoral district.*

In this quest they might support measures that promote the public good at minimum cost to the taxpayers at large. Unfortunately, such behavior fails to win many votes. Voters recognize that a single vote in Congress rarely decides an issue. Even if it should, benefits that flow to others are heavily discounted. In assigning responsibility for laws and policies of national application, voters typically view the actions of a single legislator as inconsequential.

Most voters are realistic and self-interested: they are always asking, in Alben Barkley's immortal words, "What have you done for me lately?" Public opinion surveys confirm that voters want their political representatives to "bring home the bacon." In political scientist Morris Fiorina's words, "Each of us wishes to receive a maximum of benefits from government for the minimum cost. This goal suggests maximum government efficiency, on the one hand, but it also suggests mutual exploitation on the other. Each of us favors an arrangement in which our fellow citizens pay for our benefits."[6]

Understanding voters' wishes, members of Congress promote themselves by establishing plausible claims to have channeled benefits toward and costs away from their constituents. They and their staffs spend much time on "casework," helping individual citizens cope with the terrors of government bureaucracy. Beyond casework, members of Congress strive to claim credit for "particularized benefits" that enhance the well-being of their constituents and are not available to everyone. Constituents especially value federal contracts and subsidies to local businesses; grants to local governments, schools, training programs, and sanitation facilities; federally funded dams and irrigation works; targeted loans and loan guarantees; military bases; and interstate highways and other construction projects in the district. Representatives and senators can make more politically valuable claims when they are able to point to apparently ad hoc federal largess. Political scientists disagree about the precise effect of particularized benefits on elections. But incumbents have no doubts. "The lore is that they count—futhermore, given home expectations, that they must be supplied in regular quantities for a member to stay electorally even with the board."[7]

[5]Davidson and Oleszek (1985, p. 62); Jackson (1988).

[6]Fiorina (1977, p. 40). See also Davidson and Oleszek (1985, pp. 37, 101, 435).

[7]Mayhew (1974, p. 57). See also Davidson and Oleszek (1985, pp. 412–14, 419–20); Jackson (1988, pp. 1, 29). For a counterargument, see Maass (1983, pp. 71, 261). On the electoral efficacy of casework, narrowly construed, see Johannes (1984, pp. 187–211).

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Some members bring home more bacon than others. Much of the real action in Congress happens in committees and subcommittees, "small-group settings in which individual congressmen can make things happen and be perceived to make things happen."[8] So members need to belong to the committees that have jurisdiction over the sorts of particularized benefits they wish to channel to their constituents. When a member seeks a minor favor, "the bureaucracy considers his accommodation a small price to pay for the goodwill its cooperation will produce, particularly if he has any connection to the substantive committee or the appropriations subcommittee to which it reports."[9]

One's influence on committees expands with seniority. Despite the reforms of recent years, seniority remains the most important qualification for advancement to committee and subcommittee chairmanship. In such commanding positions, one possesses a variety of ways to shape legislation. Lacking a chairmanship, ranking minority members frequently wield extraordinary clout.[10]

Besides the elevation of rank and influence that comes with seniority, members of long tenure gain the advantage of "knowing the ropes." Congressional norms, precedents, and procedures are Byzantine. Newcomers must be utterly baffled, while "members who know the rules and precedents have an advantage over procedural novices in affecting policy outcomes." Often, timing is crucial, and only those conversant with the intricacies of congressional procedure know when the most propitious moment occurs and how to seize a momentary opportunity.[11]

Notwithstanding the considerable advantages of committee membership, chairmanship, seniority, and knowing the ropes, no member can get much done without support from others. Members spend much of their time constructing and maintaining alliances. The President can be either a fine friend or formidable foe. Accordingly, one must strive to enter into mutually beneficial political exchanges with the administration. In particular, one tries to obtain favorable treatment from the President and his cabinet in the assignment of particularized benefits to one's district. The administration has much discretion in such assignments, so potential trades can often be

[8]Mayhew (1974, p. 92). See also Lindsay (1987); U.S. Senate (1985, p. 580).

[9]Fiorina (1977, p. 43). See also U.S. Senate (1985, pp. 570–80, 603–5); Reed (1984, pp. 240–41); and Lindsay (1987) for details on committee jurisdictions and power struggles in relation to defense.

[10]Davidson and Oleszek (1985, pp. 39, 219, 222–23); Mayhew (1974, pp. 104–5).

[11]Davidson and Oleszek (1985, pp. 267, 285). For a superb example, see Apcar (1983).

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arranged.[12] In such dealings, members often find it advantageous to join forces with other members from their states, frequently without regard to party membership. As House Majority Leader Jim Wright (D-Tex.) said, "When a member has his chips on the line for something that affects his district, the others pretty much fall into line and help him."[13] Increasingly, informal alliances—many of them bipartisan—have emerged along issue, regional, or commodity lines. There are, for example, a 55-member Congressional Coal Group in the House and a 39-member Coal Caucus in the Senate.[14]

Given the members, structure, and alliances, there remains the strategy. The basic problem is that members want to channel benefits toward and costs away from their own constituents. This situation would appear to be the setting for a war of each against all in a legislative Hobbesian jungle where nothing but mutually exploitative behavior could be expected. But that is not how Congress works. Indeed, its actual workings are normally just the opposite. Despite their apparent conflicts of interest, members understand that what matters most for their electoral prospects are visible particularistic benefits and costs clearly associated with the actions of individual senators or representatives. If benefits and costs are not noticed or are ignored because they are small or not clearly linked to the actions of the representatives for whom one votes, then for political purposes they do not exist. Members of Congress therefore must devise legislative strategies that enhance the visibility of particularistic benefits but that hide, obscure, or displace responsibility for the costs borne by constituents. Over the centuries, members have perfected several such strategies.

The most important strategy is logrolling, a form of vote trading that entails a tendency toward universalism: vote for my boondoggle and I'll vote for yours (maybe now, maybe later). Each of us will then have something to take plausible credit for; and even though in the aggregate the costs may vastly exceed the benefits, the voters of any given district will perceive themselves to have received net gains, to have gotten their "fair share." After all, the perceived alternative is to have borne a pro-rata share of the costs of all other boondoggles nationwide without any offsetting benefits whatever in one's own district—clearly a bad deal. Once members have positioned them-

[12]Davidson and Oleszek (1985, pp. 302–5); Weida and Gertcher (1987, pp. 22–25). On the scope for executive discretion and legislative deal-seeking in relation to defense, important contrasting cases are base closures or realignments (see Twight forthcoming) and placement of subcontracts (see Mayer forthcoming).

[13]Wright as quoted in Davidson and Oleszek (1985, p. 362).

[14]Davidson and Oleszek (1985, pp. 364–65); Lindsay (1987); U.S. Senate (1985, p. 579).

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selves on committees of greatest serviceability for their reelection strategy, "observance of reciprocity is not very costly in terms of lost opportunities, and it is very profitable in terms of unfettered influence in an area vital to their continued reelection."[15] Rep. Ronald V. Dellums (D-Calif.), chairman of the House Armed Services Subcommittee on Military Facilities and Installations, gave voice to the prevailing practice when he said that "as long as 'powerful' members can get their projects through it would be discriminatory to vote against anyone else."[16]

Another important legislative strategy for facilitating the members' diverse objectives is improvising a package deal. By attaching riders (that is, substantively unrelated provisions) to a comprehensive bill, such as the appropriation bill for an entire federal department, legislators are able "to execute a hidden ball play. The broader the scope of the measure, the more chance there is of its carrying along to enactment provisions that would otherwise stand no chance of being enacted into law." Within omnibus bills—recent examples include appropriations measures covering funding for several departments, bills that may run to hundreds of pages and allocate hundreds of billions of dollars—riders occupying a few lines easily gain enactment with little effort by their sponsors. Nor do the sponsors of such riders need to worry about a presidential veto.[17]

An especially innocent-looking variant is the "limitation rider," which restricts the use to which an agency may put appropriated funds. As political scientists Roger Davidson and Walter Oleszek note, however, such riders actually "make policy" under the guise of restricting expenditures.[18] Recent defense appropriations acts, for

[15]Fiorina (1977, p. 67). See also Mayhew (1974, pp. 88, 105, 114–16, 119); Davidson and Oleszek (1985, pp. 116–17, 193, 223, 398–401).

[16]Dellums as quoted in Weida and Gertcher (1987, p. 83).

[17]Gross (1953, p. 209). See also Mayhew (1974, p. 114); U.S. Senate (1985, pp. 588–89); Weida and Gertcher (1987, p. 25). The omnibus spending bill for fiscal year 1988 signed by President Reagan on December 22, 1987, which included the defense appropriation, had more than 2,000 pages and appropriated more than $600 billion. Senator Daniel Evans (R-Wash.) recently wrote that on the evening of December 22, 1987, "I was speaking in the Senate about the impossibility of even knowing what we were about to vote on when the doors opened and a messenger from the House entered carrying a large cardboard box containing the 2,100-page bill. As they approached the presiding officer, the shouts of 'Vote! Vote!' forced me to end my remarks, and in less than half an hour the Senate had adopted a $604 billion budget that not one senator had fully read. Weeks later, we were still discovering special little provisos that members of the Appropriations Committee had inserted into the bill" (Evans 1988, p. 50; see also p. 91). One of those "little provisos" had to do with anthracite coal; see my concluding section below.

[18]Davidson and Oleszek (1985, p. 328). See also Maass (1983, pp. 136–38).

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example, contain dozens, sometimes scores, of limitation riders. Behind each of them, there is a story; usually it is a story of particularistic benefits conveyed to a special interest group by an individual member or a small group of members of Congress.

"The most pervasive attribute of electoral processes," write Davidson and Oleszek, "is their local character. . . . The candidates, the voters, and often the issues and styles, are deeply rooted in states and districts." And yet, "the aggregate of all these contests is a legislative body charged with addressing national problems and issues."[19]

The residents of the United States need, *inter alia*, national defense—not defense of merely the Second District of California or the state of Idaho but *national* defense. Yet no one in Congress has much incentive to promote the national defense. In fact, all members face incentives and constraints that push them toward support of measures that weaken the national defense by depleting the defense budget to finance particularistic benefits that do nothing to produce genuine national security. Worst of all, selling out the national defense apparently violates no political norm, at least no congressional norm. As a British writer has observed, somewhat aghast, "It would not be thought unusual or wrong for either senators or congressmen to argue for the interests of their state or district even if those interests appeared to the majority to be *contrary* to the national interest."[20]

Except when acting ideologically or seeking electoral gains from public position-taking, an individual member of Congress tends to regard national security and other essential collective goods as conditions beyond control, like acts of God, even though they are the result of the aggregate of actions taken by members of Congress. "It makes much more sense," writes political scientist David Mayhew, "to devote resources to things over which they think they can have some control" and for which they can claim individual credit during the next campaign.[21] Given the structure of our legislative institutions and the strategies of the legislators, "the general, long-term welfare of the United States is no more than an incidental by-product of the system."[22]

On the basis of analysis like that just presented, several political scientists have argued that the growth of the federal government, especially the expansion of the scope of federal activities, has led to

[19]Davidson and Oleszek (1985, p. 101).

[20]Hobkirk (1983, p. 54, emphasis added). See also "Weapons Industry Lobby," pp. 89–92; Feld and Wildgen (1985, pp. 41–43); Russett (1970, pp. 186–87); Aspin (1981).

[21]Mayhew (1974, p. 32).

[22]Fiorina (1977, p. 49).

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a change in the mix of congressional activities: less attention to setting basic policies, more attention to casework and pork barreling. As one congressman put it, "The federal government has projected itself into every aspect of life, from cradle to grave; so people naturally go to Washington to solve their problems." Because so many more people are now likely to have troubles with the federal bureaucracy and so many more opportunities exist to procure particularistic benefits from the federal government, the payoffs have been shifted for legislators. There are now more opportunities for them to take the sorts of actions that best promote their reelection, and they have responded accordingly.[23]

The analysis may be applied to the defense program in particular. Throughout the post–World War II era, the United States has maintained an enormous military establishment, requiring thousands of bases and other facilities, millions of workers, and a multitude of contracts for research, goods, and services supplied by private firms. The governmental allocation of these bases, jobs, and contracts involves great discretion. Members of Congress have recognized that post offices and rivers-and-harbors projects, the traditional pork-barrel measures, are now small potatoes. As Rep. Pat Schroeder (D-Colo.) complained in the early 1980s, no doubt exaggerating somewhat, "If you want anything for your district . . . the only place there is any money at all is in the Armed Services Committee bill."[24] Since World War II the U.S. Treasury has laid out more than $6,600 billion (in 1982 dollars) for national defense. The potential for pork barreling has become stupendous, and members of Congress have been alert to seize the opportunities, often in ingenious ways.

The Hard-Coal Constituency and Its Congressional Salvation

Anthracite is the hard, shiny coal that burns hot, clean, and almost without flame. It is found in the United States almost entirely in a small region of northeastern Pennsylvania. (For present purposes it suffices to say that we are dealing with no more than four congressional districts.) The anthracite industry grew rapidly in the late 19th and early 20th centuries, but after World War I it began to decline. By 1960 the industry was a shadow of its former self: output at 18 million tons (down 72 percent since World War I), employment at

[23]Congressman as quoted in Johannes (1984, p. 37). See also pp. 36, 55, and Fiorina (1977, pp. 46–49, 87–93).

[24]Schroeder as quoted in Lindsay (1988, p. 65). See also Weida and Gertcher (1987, pp. 22–25, 82–83); Bacon (1978); Mossberg (1983).

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20,000 workers (down almost 90 percent since 1914).[25] The hard-coal region became a classic economic backwater. But despite the unemployment, outmigration, and despair, not all was lost. The region still had congressmen.

The congressmen had influence with the administration, and they perceived that its management of the defense program might be turned to the advantage of the shriveling anthracite coal industry. The United States had hundreds of thousands of troops stationed in Europe, giving rise to a demand for a million metric tons of solid fuels annually to heat the barracks. Those fuels, bituminous coal and coke, were being purchased from European suppliers. Someone got the idea that substituting Pennsylvania anthracite for German coke could add substantially to the withering market for hard coal. Industry leaders Harry W. Bradbury of the Glen Alden Coal Company and James J. Tedesco of the Pagnotti Coal Company took the initiative in "creating a market where none had existed before." They invested "large measures of tenacity, travel and tact and after six months of effort they prevailed." Their herculean efforts were not directed at producing or marketing coal; they were aimed at lobbying the state's congressional delegation and the administration.[26]

In May 1961 a meeting in Washington of all the interested parties was arranged by the congressmen with constituents in the hard-coal region. In attendance were Pennsylvania's Senators Joseph S. Clark and Hugh Scott and Representatives Ivor D. Fenton, Daniel J. Flood, William W. Scranton, and Francis E. Walter. Representing the Pentagon were Edward J. Sheridan, deputy assistant secretary of defense, General J. B. Lampert, director of military construction, and other high officials of the Department of Defense (DoD) and the Army. Representatives of the United Mine Workers and the anthracite producers rounded out the group. On the agenda were two items: (1) opposition to conversions from anthracite to alternate fuels by the Army anywhere; and (2) a proposal that the Army switch from German coke to Pennsylvania anthracite at its European posts. At stake was the potential opportunity to supply some 700,000 tons of solid fuel. The immediate outcome of the meeting was that Paul A. Mulcey, a consulting engineer connected with the Pennsylvania Coal Research Board, was dispatched to West Germany "to inspect and investigate the plants in question to ascertain whether there is any

[25]Miller and Sharpless (1985); Pennsylvania Department of Environmental Resources (n.d., pp. 41–43); Powell (1980); *Congressional District Data Book* (1963, pp. 428–29).
[26]"Impact of the Army Tonnage" (1961, p. 2); "Defense Seeks U.S. Coal for Troops in Germany" (1961, p. 45).

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valid reason why Pennsylvania anthracite cannot be used as economically and efficiently as German coke." As the summer passed, the people of the hard-coal region looked forward anxiously to an arrangement that might entail 318,700 man-days of work, $6,700,000 in wages, $7,700,000 in sales, and all the multiplier benefits to "bolster the economy of the distressed anthracite producing region." In anticipation of these benefits, the *Bulletin* of the Anthracite Institute gratefully recognized the congressmen's "effective work in bringing about a new appraisal of anthracite" by the Army and DoD; it expressed its great appreciation and extended "the industry's sincere thanks."[27]

The scheme was nonpartisan. Senator Clark was a Democrat, Senator Scott a Republican. Representatives Flood and Walter were Democrats; Scranton and Fenton were Republicans. They had but one thing in common: each represented a voting district consisting in part of voters resident in the hard-coal region. Flood's Eleventh District was Luzerne County; Walter's Fifteenth District included Carbon County; Scranton's Tenth District included Lackawanna County; Fenton's Twelfth District included Northumberland and Schuylkill counties. Together they covered virtually all of the hard-coal fields still being worked.[28] Together they packed considerable clout—and got results.

In October the Pentagon announced that its forces in West Germany would purchase over 485,000 net tons of Pennsylvania anthracite in the next eight months. The announcement was, according to the *Bulletin* of the Anthracite Institute, "the most exhilarating news that the industry and the producing region have received in a long time." The new sales represented an amount equal to about 20 percent of the total production of stove coal and larger sizes. Beyond the benefits to the mining industry, the program promised substantial stimulus to the railroad and supplying industries. Some 8,660 extra carloads would be required to carry the European-bound shipments to tidewater piers; hence, some $118,000 in wages for railroad employees per anthracite working day. The beneficiaries were encouraged by getting the program going even though the Army had already contracted for a portion of its fuel supplies in Germany earlier in the fiscal year. It seemed "not unreasonable to anticipate" that the Pennsylvanians would be in a "much more favorable position to obtain an even greater tonnage in the year beginning July 1, 1962."[29]

[27]"Army Tonnage" (1961, p. 1).

[28]*Congressional Directory* (1962, pp. 139–141).

[29]"Impact of the Army Tonnage" (1961, p. 2); "Ten Solid Trainloads of Anthracite Per Day" (1961, p. 1).

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Indeed they would be, for a government program is an easy thing to start, a hard thing to stop. Besides, this particular program could be clothed in a variety of plausible public-interest rhetoric. It was said to express President John F. Kennedy's interest in improving the nation's balance of payments, raising the gross national product, aiding economically distressed regions, and decreasing unemployment. The only losers seemed to be the German coke suppliers, "who need no help at this point." In April 1962 the *Bulletin* concluded: "This government business has done so much to further the President's stated national objectives and coincidentally bolster the local economy, that it is clearly in the best interests of all parties that it not only be continued, but expanded for the year starting July 1st."[30]

And so it was. In July 1962 the Department of Defense announced that it would award contracts to anthracite firms for about 500,000 net tons for shipment to West Germany. This time 10 firms shared the business and with the benefits more widely spread a deeper entrenchment of the program was ensured. Jobs, of course, would appear to be created. The contracts represented about 21 percent of annual production of stove coal and larger sizes and would require a minimum of two and a quarter weeks of union production. In addition, supply, service, and transport firms and their workers would gain. Some 120 more railroad workers would be needed to get the coal to ocean ports, where U.S. flag vessels and their crews would begin to get their share.[31] Everybody seemed to be better off. Not a word was spoken about the additional government outlays needed to conduct the program. Thereafter it was extended year after year as a matter of course.

By the late 1960s, however, the Pentagon had wearied of this coals-to-Newcastle scheme. Military authorities proposed conversions of the aging, inefficient, and labor-intensive anthracite furnaces in Europe to more modern designs using alternate fuels, usually oil. They expected thereby to save over $20 million a year. But DoD's requests for budget authority to convert the furnaces got nowhere in Congress. The proposal repeatedly failed to clear the Defense Appropriations Subcommittee of the House. Year after year the mighty Pentagon met defeat at the hands of a single congressman. The defense officials

[30]"Renewal of the Army Export Contract" (1962, p. 1).

[31]"Export Tonnage for U.S. Army to Be Continued" (1962, p. 1). See also "Anthracite Shipments to Army Continue" (1962, p. 43).

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should not be faulted too much, however, because their opponent was "the best congressman."[32]

The Best Congressman: Dan Flood

Everyone agreed that Daniel J. Flood, the Democratic representative of the Eleventh District of Pennsylvania, was the best congressman. Most important, his constituents agreed. They elected him to Congress first in 1944 and—except in 1946 and 1952, when the Republicans enjoyed nationwide triumphs—reelected him at every election through 1978. Once, running unopposed in 1970, he received 97 percent of the vote. After he had entrenched himself, in the 1960s and 1970s, Flood routinely won by a large margin even when opposed. For 16 terms, he served as the "guardian angel" of the people of his district. He was an ombudsman, father, priest, employment bureau, entertainer, fixer, occasionally a savior. He was, in the words of one adoring constituent, "the next closest thing to God."[33]

Flood had what political scientists call a consummate "home style." He understood the people of his district and knew what they wanted from him. His constituents—predominantly members of white ethnic groups descended from hard-pressed immigrant miners, long isolated by occupation, ethnicity, and geographical remoteness from the mainstream of national political life—had little interest in matters beyond their Appalachian province. "Local, not national or international, issues mattered most to people. Voters wanted to know what a candidate could do for them—for their family, for their town, for their region of the country. The politican who did not understand this concern simply did not get elected."[34] Flood understood.

Fundamental to the power of this congressman who "wield[ed] his power ruthlessly to channel untold millions of federal dollars into his district" were seniority, advantageous subcommittee memberships, and rank. By the 1960s he had become the second-ranking Democrat on the Defense Appropriations Subcommittee. In 1967 he became chairman of the Labor and Health, Education, and Welfare Appropriations Subcommittee. In these two positions, he boasted, he was "identified with three-fourths of the whole federal budget. You can imagine what that means." Spelling out his strategic advantages for reporter George Crile in 1974, Flood explained: "You get to be known, and while you don't threaten anyone—they are very

[32]Stubbing (1986, p. 100); Crile (1975, p. 63).

[33]Crile (1975, p. 61); "Flood, Daniel J(ohn)" (1979, p. 134).

[34]Miller and Sharpless (1985, p. 331). On home style, see Mayhew (1974, p. 51).

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understanding people and very human. . . . It's very technical and I use all of these opportunities, advantages, seniority, and all of this stuff for the purpose of helping whatever is left of the goddamn anthracite coal industry." With his subcommittee positions and rank, Flood had a lot to trade. His congressional colleagues appreciated the potential for gains from trade. Said House Speaker Carl Albert (D-Okla.), "Flood's in a position to accommodate a lot of members."[35]

And accommodate he did. Flood was as popular with his fellow members of Congress as he was with his constituents in the Eleventh District. As Rep. Joe Waggonner of Louisiana put it, Flood was "a Congressman's Congressman." Rep. Tom Steed of Oklahoma echoed Waggonner's appraisal: "It's true that I do more for Dan Flood than I do for other members of Congress. It's because Dan Flood can do more for me than other members of Congress." Flood became a horse trader supreme. His IOU's were distributed "throughout the power structure of the House, hitting every region and committee, and extending to both parties." He viewed a plea for help from a colleague as "an opportunity rather than a burden." If he needed to be paid back, as when in 1972 the Susquehanna River flooded much of Wilkes-Barre and other places in his district, he could say to his colleagues, "Now look, goddamn it, I've taken care of you before, now you get in line."[36] And they did.

When the Army proposed conversion of its European furnaces from anthracite to oil in the late 1960s, Flood used his strategic position on the Defense Appropriations Subcommittee to block the budget authority required for the conversion. "Hell, yes, I stopped it," he bragged to Crile. "I did it by twisting arms and hammering heads. I'd break a few arms if I had to." The former boxer was hyperbolic as usual. In truth, he possessed far more effective means of getting his way than physical prowess. In 1972 he gave the anthracite industry's captive military market even stronger protection by adding to the Defense Appropriation Act for fiscal year 1973 the following limitation rider: "None of the funds available to the Department of Defense shall be utilized for the conversion of heating plants from coal to oil at defense facilities in Europe."[37] Thereafter, the same provision—two-and-a-half innocuous-looking lines tucked obscurely into a bill with hundreds of complex sections—reappeared year after year. The U.S. Army therefore was stuck with its anthracite furnaces

[35]Quotations from Crile (1975, pp. 60, 64—65) and "Flood, Daniel J(ohn)" (1979, p. 133).
[36]Waggoner, Steed, and Flood as quoted in Crile (1975, p. 65).
[37]Flood as quoted in Crile (1975, p. 63); 86 Stat. 1184 (1972) at 1203.

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and had to continue buying, transporting, storing, and handling the hard coal to fuel them.

Over time the anthracite program was costing DoD—which is to say, the taxpayers—hundreds of millions of dollars in excessive heating costs. Why, a writer asked Flood, did the defense authorities let him get away with his costly obstruction? "They can't be blamed," he answered. "After all, here's Flood, a nice fellow, and he's got a great reputation for being for defense appropriations—bang, bang, bang, and all that. Jesus Christ, suppose you were one of these goddamn generals or secretaries or deputy secretaries. What are you going to do? Jeopardize the Army materiel command with a son of a bitch like that for a couple of million dollars, for a couple of tons of coal? Bullshit."[38] Obviously the congressman had the military authorities over a barrel. Having more important projects to promote and fund, they did not consider it worthwhile to antagonize a powerful member of the Defense Appropriations Subcommittee in order to save the few hundred million dollars consumed by his favorite boondoggle.

Flood eventually met defeat, not at the hands of his constituents, who loved him to the end, but in federal court, where he was charged in the late 1970s with a variety of offenses including perjury, conspiracy, and acceptance of bribes. In a plea bargain struck in February 1980, he was found guilty of conspiracy to violate federal campaign laws. In consideration of his old age and ill health, he was given a suspended sentence and placed on a year's probation. He resigned his congressional seat on January 31, 1980.[39]

The Second-Best Congressman: Joe McDade

Joseph M. McDade is a dull man, in appearance, speech, and behavior the very opposite of Dapper Dan Flood. But politically McDade has much in common with Flood, who represented an adjacent congressional district and with whom he worked amiably for almost two decades in the service of the anthracite region in general and the hard-coal industry in particular. Now serving in his 13th term, McDade is the senior member of the Pennsylvania delegation. Though a Republican, he enjoys the support of organized labor. His appeal is to members of both parties. Avoiding strong partisan and ideological positions, he has never received less than 60 percent of the vote since 1966. He is "a model casework congressman, the kind

[38]Flood as quoted in Crile (1975, p. 63).

[39]Orlofsky (1979, pp. 239–40, 500, 685); "Flood, Daniel J(ohn)" (1979, p. 134); Orlofsky (1981, p. 190).

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who sometimes seems to function as little more than an ambassador for his district."[40]

Given his seniority, what is most conspicuous about McDade is his inconspicuousness. But lack of publicity has not kept him from cultivating influence with his congressional colleagues. "He is one of those guys who is very effective by learning the ropes and being a nice guy," says Rep. Morris Udall of Arizona. "I don't know anybody who doesn't like him." According to Rep. Don Young of Alaska, "He has the ability to put together packages that are acceptable to everyman." Unknown to the public outside the anthracite region, he makes a deeper impression on his colleagues. Rep. Jack Murtha of Pennsylvania has said that "it would be difficult to have much more influence" than McDade has now.[41]

Like Flood, McDade built his congressional career on seniority, committee membership, and rank—all employed in the cause of ample casework and generous infusions of particularistic benefits for the homefolks. He is, as one political guidebook puts it, "a creature of the Appropriations Committee."[42] In 1985 he gave up his position as ranking minority member of the Interior Appropriations Subcommittee, where he "always fought for the interests of coal," to become the ranking Republican on the Defense Appropriations Subcommittee. Like Flood, he "isn't bashful about funneling funds to General Dynamics and other Pentagon contractors with plants in his district"; nor is he "shy about shovelling federal money into the anthracite country or protecting the interests of coal."[43] So even after Flood had left the scene, that same limitation rider, forbidding conversions of European base furnaces from coal to oil, kept appearing in the defense appropriations bill year after year. After all, the Eleventh District, like all the others, "wants a piece of the military-industrial complex to call its own."[44]

[40]Naughton (1987, pp. C1–C2); Barone and Ujifusa (1985, pp. 1167–68); Barone and Ujifusa (1987, pp. 1031–32); Ehrenhalt (1981, pp. 1043–45).

[41]Udall, Young, and Murtha as quoted in Naughton (1987, pp. C1–C2).

[42]Ehrenhalt (1981, p. 1043).

[43]Barone and Ujifusa (1985, p. 1167); Barone and Ujifusa (1987, p. 1031). One wonders whether McDade's 1985 move to the Defense Appropriations Subcommittee had anything to do with his receipt of $26,700 from the PACs of the 20 top defense firms in support of his 1984 campaign. See Parry (1985). Recently, announcing his intention to seek a 14th term, McDade boasted that his current term "may have been his most successful in bringing jobs and economic growth" to his district ("McDade Announces Bid for 14th Term" [1988]).

[44]See, for example, 95 Stat. 1565 (1981) at 1585, and 96 Stat. 1833 (1982) at 1857; Naughton (1987, p. C2).

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With 25 years of experience in pork-barrel politics, McDade expresses no shame about his sponsorship of the anthracite boondoggle. "I guarantee you," he proudly told the *New York Times*, "that if we weren't burning [anthracite] coal in Europe we wouldn't be burning it anywhere. This is a way to keep the industry alive." To clothe this domestic welfare program in a thin garment of military rationality, some supporters have alleged that in its absence the German bases would be vulnerable to energy blackmail because of European dependence on Soviet natural gas or Persian Gulf oil and the possibility of terrorist attacks on the pipeline system. The argument is pathetic and can be exploded by a moment's reflection. U.S. Army officials have rejected it, maintaining that district heat or oil-fired systems present no greater security risk than coal-fired plants. Still, McDade is happy to trot out the discredited security argument. "I'll be doggoned if I'll tell the people that they're going to heat their bases with Russian gas," says the mock-patriotic congressman. "It's not unseemly to ask that United States coal be burned on a United States base."[45]

In late December 1982, McDade and other congressional friends of coal added to the Defense Appropriation Act for fiscal year 1983 the following rider: "None of the funds available to the Department of Defense during the current fiscal year shall be used by the Secretary of a military department to purchase coal or coke from foreign nations for use at United States defense facilities in Europe when coal from the United States is available."[46] The provision gave added assurance that the hard-coal industry would retain its captive military market.

Diplomacy and Economy versus the Pork Barrel

While Congress played games with taxpayers' money, a diplomatic confrontation was steadily building in Germany. At its root were the old anthracite furnaces on U.S. bases. The furnaces caused a lot of air pollution in a heavily industrialized area already subject to severe air pollution. Damage to German forests accelerated rapidly in the early 1980s; by 1985 nearly half the trees had been affected. The Germans reacted by imposing stringent antipollution standards,

[45]McDade as quoted in Gruson (1986, p. 26). For a presentation of the security-risk argument for coal-fired plants, see the remarks of David G. Wigg inserted into the record by Senator Heinz, *Congressional Record* 132 (8 August 1986, pp. S10845–S10846). For the Army's refutation of the argument, see U.S. General Accounting Office (1987, pp. 3, 24–25).

[46]96 Stat. 1833 (1982) at 1863.

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including requirements that existing boilers be retrofitted with scrubbers and, in some areas, that no coal be burned regardless of the equipment. According to the DoD's 1985 energy management plan, "German officials at all levels are unalterably opposed to the use of coal (any kind, from any country) where connection to a local district heating system is an available alternative. . . . The Department of Defense is becoming increasingly unable to comply with congressional direction on U.S. coal use in Europe and German law." The Pentagon found itself, in the words of Jeffrey Jones, acting director for energy policy, "pinned between U.S. law and German law."[47]

In a letter surveying the problem, Gen. Scott B. Smith, the deputy chief of staff, engineer, for the U.S. Army in Europe, cited a study that estimated the Army could save about $500 million over the 25-year life cycle of its heating equipment if congressional restrictions on conversions were removed. Further, removal of the restrictions "would greatly enhance the image of the U.S. Army in the eyes of the German government and its citizens." Smith noted that "good relations with Host Nations are our greatest assurance of gaining their support for the fielding of new weapons systems, the construction of new facilities, and the needed cooperation in realizing other common aims." High-level diplomatic communications underscored the seriousness of the irritation of German-American relations. The German minister of finance wrote Secretary of Defense Caspar Weinberger to emphasize that "using local district heating facilities would be in the common interest of maintaining and strengthening the cordial relations between the U.S. forces and the local population." The German foreign minister wrote Secretary of State George Shultz to point out "the importance of the heating issue for maintaining the good relations between the forces and the local population." And the German ambassador, Gunther van Well, wrote Senator Barry M. Goldwater, chairman of the Senate Armed Services Committee, seeking support for legislation to drop congressional restrictions on conversions of European furnaces.[48]

Faced with the excessive costs of continuing to operate the anthracite furnaces, including the prospect of some $385 million of additional defense budget outlays just to bring them into compliance with German environmental regulations, and the growing diplomatic flap

[47]Major General Scott B. Smith to Major General Richard K. Kenyon, 19 May 1986 as printed in *Congressional Record* 132 (8 August 1986, pp. S10844–S10845); DoD energy management plan as quoted in Copulos (1986, p. 5); Jones as quoted in Gruson (1986, p. 26). See also "Defense Department Wants to Stop Buying U.S. Coal" (1986, p. 17).

[48]For the letters, see *Congressional Record* 132 (8 August 1986, pp. S10844–S10845).

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with German authorities, Congress took action—and made the problem even worse.

The Defense Appropriations Act for fiscal year 1985, passed by Congress in October 1984, included the standard restriction on conversions of European furnaces from coal to oil; it also carried forward the requirement, first enacted in 1982, that all coal used on European bases be U.S. coal. Still open, however, was the alternative being pressed by the Germans that the bases switch to district heating, tapping into networks of surplus heat produced by nearby factories, mills, and utilities. Ever vigilant, Rep. McDade slammed shut that door, too. Just before the defense appropriations bill left the House Appropriations Committee in September 1984, McDade attached an amendment providing that "none of the funds available for Defense installations in Europe shall be used for the consolidation or conversion of heating facilities to district heating distribution systems in Europe."

The Defense Department, already engaged in negotiations with several local authorities in Germany for just such conversions, protested the committee's action. In response, the Senate Appropriations Committee conceded "that those facilities identified by the Department of the Army as of September 24, 1984, as being in advanced stages of negotiations shall be exempt from such provision upon written notification to the Committees on Appropriations of the House of Representatives and the Senate from the Department justifying the conversion for each facility." Offsetting its slight concession, however, the Senate committee directed the Army to purchase an additional 520,000 metric tons of U.S. coal to build a one-year "strategic reserve" in Europe. These reserves, according to Gen. Smith, were "not needed." The Senate provision, subsequently enacted by Congress, would simply add to existing, already sufficient reserves at a cost of $63–75 million—more than $17 million for transport alone. But the sponsor, Pennsylvania's Republican Senator Arlen Specter, was delighted to announce the action and to characterize it as "good news for the anthracite coal fields."[49]

Every Pentagon protest, every diplomatic difficulty, every additional extraction from the taxpayer's pocketbooks seemed only to whet the congressmen's appetite for more pork. McDade, as always, had "worked closely with the anthracite industry." Specter, facing a close race in 1986, began to play a more prominent role in the

[49]Smith to Kenyon, *Congressional Record* 132 (8 August 1986, p. S10844); 98 Stat. 1904 (1984) at 1926, 1928, 1934, 1941; Copulos (1986, p. 4); Specter as quoted in "Coals to Newcastle" (1985, p. 12).

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diversion of defense funds to the anthracite region. In appreciation, the National Coal Association and its political action committee (Coalpac) designated him a priority candidate and contributed $2,000 to his campaign (out of a total of $15,750 given to all Senate candidates between January 1985 and June 1986).[50] PACs sponsored by individual coal companies and the United Mine Workers made additional contributions. McDade, as expected, and Specter, with relief, easily won reelection in 1986.

A cynic might well have viewed the campaign contributions from the coal interests as a naked payoff for actions taken in Congress in 1985, when the boondoggle reached its height. That year, seeking to escape from the untenable position in which conflicting German and American laws had placed it, the Department of Defense proposed a "Solomonic compromise." In a letter dated August 30, 1985, the assistant secretary of defense for acquisition and logistics proposed to the Senate Defense Appropriations Subcommittee that in exchange for a lifting of the restrictions on furnace conversions in Europe, the department would increase the use of coal for heating its bases in the continental United States. Coal purchases would be increased—indeed, more than doubled—by 1.6 million short tons (including at least 300,000 tons of anthracite) by fiscal year 1994.[51] When the conferees finished their reconciliations and the Defense Appropriations Act for fiscal year 1986 finally became law on 19 December 1985, it was the best Christmas present ever for the coal interests. It continued all the previous restrictions on DoD energy use in Europe: no coal-to-oil conversions, no foreign coal, no conversions to district heating (except at those bases the Army identified as of April 11, 1985, as being in advanced stages of negotiation and at Bad Kissingen).[52] So DoD's proposed deal had fallen through. But Congress did accept part of the proposal, the pork-barrel part: it mandated increased use of coal on bases in the continental United States. To implement an amendment sponsored by Senator Robert C. Byrd of West Virginia, funds were provided to pay for conversion of furnaces on domestic bases from gas or oil to coal. Section 8110 of the act reads:

> Of the funds available in the Army Industrial Fund, $25,000,000 shall be available to be used to implement immediately, or to transfer to another appropriation account in this Act to be used to implement immediately, the program proposed by the Department in its

[50]"Coals to Newcastle" (1985, p. 12); "Coalpac Supports Candidates in Four Key Senate Races" (1986, p. 13).

[51]Gruson (1986, p. 26); "Defense Department Wants to Stop Buying U.S. Coal" (1986, p. 17); Copulos (1986, pp. 1, 4); *Congressional Record* 132 (8 August 1986, p. S10844).

[52]99 Stat. 1185 (1985) at 1205, 1207, 1210, 1214.

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> letter of August 30, 1985, from the Assistant Secretary of Defense for Acquisition and Logistics, to rehabilitate and convert current steam generating plants at defense facilities in the United States to coal burning facilities in order to achieve a coal consumption target of 1,600,000 short tons of coal per year above current consumption levels at Department of Defense facilities in the United States by fiscal year 1994; *Provided,* That anthracite or bituminous coal shall be the source of energy at such installations; *Provided further,* That during the implementation of this proposal, the amount of anthracite coal purchased by the Department shall remain at least at the current annual purchase level, 302,000 short tons.[53]

For the first time, a statute had actually prescribed a minimum tonnage of hard coal that the Pentagon must buy—it was micromanagement with a vengeance.

This legislation anticipated the conversion of heating systems to use coal at 37 installations in the continental United States. Estimates of the costs of the conversions varied widely, from about $1.4 billion according to the Department of Defense to as much as $5 billion according to analyst Milton R. Copulos, director of energy studies at the Heritage Foundation.[54] Copulos placed the congressional coal scheme "among the most astounding examples of parochialism" but noted, with reference to the military authorities, that "no one wants to get the people [in Congress] who write your budget mad." Congressman William E. Dannemeyer of California's Thirty-Ninth District—an Orange County district conspicuously short of coal mines—expressed outrage at the program. "It's a joke," he declared, "a terrible, sad example of porkbarrel politics"; but it exemplified "how our political process works."[55]

It was either too good (for coal-state members of Congress and their privileged constituents) or too bad (for everyone else) to last. With the Pentagon still caught in the middle and with gas-state representatives in Congress bringing pressure to preserve gas sales to military bases in the continental United States, the scheme had to be altered; and in 1986 it was.[56] Along the way a revealing debate took place in the Senate.

In early August, as the senators were laboring through days of lengthy sessions to consider scores of proposed amendments to the

[53]99 Stat. 1185 (1985) at 1222.

[54]Copulos (1986, p. 6).

[55]Copulos and Dannemeyer as quoted in Gruson (1986, p. 26). See also "Defense Department Wants to Stop Buying U.S. Coal" (1986, p. 17).

[56]"U.S. Bases in Europe to Stop Using Pa. Coal" (1986). Michael Baly, vice president of the American Gas Association, reported that "We raised a lot of hell on Capitol Hill and talked with some of our friends" (Wessel 1988).

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defense authorization bill, Specter offered an amendment cosponsored by fellow Pennsylvania Republican John Heinz, Byrd and John D. Rockefeller of West Virginia, and Paul S. Trible of Virginia. The amendment called essentially for reenactment of the provision passed in 1985 requiring DoD to implement the plan to increase its coal consumption by 1.6 million tons, including at least 300,000 tons of anthracite, in the continental United States by fiscal year 1994 by converting furnaces. Speaking in support of the measure, Specter, who faced an uncertain election just three months away, underscored the supposed lessons of the 1973 Arab oil embargo and the dangers of dependence on foreign energy materials. He stressed the importance of supporting domestic energy sources. By adopting his amendment, the Senate could continue its "commitment to the American coal industry" and ensure that "the U.S. coal producers, railroads, maritime industry, and our Nation's security will not be jeopardized."

Heinz then spoke in support of the amendment, noting that it was "the result of years of discussions and planning by the Defense Authorizing and Appropriations Committees in both Chambers." He expressed "deep reservations" about letting DoD off the hook in Europe and worried that the military authorities might manage their energy use to the detriment of the coal industry. The amendment, he declared, would "guarantee a livelihood to some 2,000 to 3,000 coal miners in Pennsylvania" and, by the by, avoid grave repercussions for national security "that can not be underestimated." Byrd spoke briefly in support of the amendment, explaining that it would ensure that "there will be no misunderstanding or faltering by the Defense Department in the pursuit of this program in fiscal year 1987."[57]

Senator Strom Thurmond of South Carolina, the floor manager of the bill under debate, explained that Specter's amendment should be viewed in the context of other provisions of the bill approved by his subcommittee. At long last the Armed Services Committee had approved conversion of heating plants at defense facilities in Europe "from coal to district heat or gas or oil whenever it is cost effective or required by the host nation." This would allow savings of $20–40 million in annual operating costs and preclude the necessity of installing antipollution devices at a cost of $385 million to comply with German environmental regulations. Acknowledging the political swap being made, Thurmond characterized Specter's amendment as part of "an orderly transition from using coal in Europe to using coal in the United States." His committee, having considered the

[57]*Congressional Record* 132 (8 August 1986, pp. S10842–S10843).

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new coal requirements, was "willing to make that concession in order to get the big plan approved."[58]

At that point Senator Phil Gramm of Texas interjected some sour notes. He did not intend to oppose Specter's amendment, he said, because it was "a step in the right direction." But he reminded his colleagues that "in the name of domestic politics, we have literally been carrying coals to Newcastle. . . . It is absolutely absurd policy which cheats the taxpayer and creates tremendous problems with our allies." The compromise being proposed "may be an improvement, but it is plain wrong as far as foreign policy and defense are concerned." He called it "an absolute outrage" that ought to be stopped and promised that in the future he would not compromise on the issue. Senator Ted Stevens of Alaska agreed. He noted the opportunity cost of the coal program: "We are now buying more coal than we need," and such purchases divert dollars from buying airplanes, research, and other things required for national defense. "This is an entitlement," he concluded. "Let us make sure everyone understands."[59] No doubt everyone did. Specter's amendment was adopted by a voice vote.[60]

Later that day, when the Senate was debating another defense boondoggle—to use strategic stockpiling to create a de facto domestic subsidy—Senator Gramm reflected on what the Senate had done earlier with respect to coal:

> Why did we do that? We did it because of the logrolling buddy system that somebody wanted to do something to help their region. It was only the taxpayer paying for it, so we all looked the other way. We created international problems with the Germans by forcing the burning of high-sulfur coal when they had low-sulfur coal. We created the absurdity of paying a higher price for coal, then paying huge transportation costs and coming over and burning it on the very site that we could have bought cheaper coal with no transportation cost and lower sulfur. And we did that because the Con-

[58]*Congressional Record* 132 (8 August 1986, p. S10843). It has become increasingly popular for members of Congress to introduce floor amendments to defense authorization bills; by 1985 more than 100 were introduced in each chamber. See U.S. Senate (1985, pp. 589, 601, 610). As the Senate report (p. 601) points out, "This poses a dilemma for the floor managers. Fighting superfluous amendments would prolong the debate and add to its contentiousness. It is much easier to modify amendments to make them relatively benign and accept them on the floor, rather than fight them. This establishes a pattern, however, of yielding to almost any member's wishes for the sake of expediency in securing adoption of the bill." See also Lindsay (1988, p. 64).

[59]*Congressional Record* 132 (8 August 1986, p. S10843).

[60]*Congressional Record* 132 (8 August 1986, p. S10846).

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> gress was micromanaging resources and we had political logrolling going on."[61]

No one denied the charge.

Ultimately, Specter's amendment was enacted as section 9099 of the 1987 Defense Appropriation Act, passed in October 1986. The section called for the 1.6 million tons (including at least 300,000 tons of anthracite) to be added to DoD purchases by fiscal year 1994 but provided that the fuel used in any new or converted heating system be the most cost effective. Again, to make certain that anthracite kept its captive market during the transition, the law stipulated that DoD buy at least 300,000 short tons of anthracite during fiscal year 1987.[62]

The 1987 Defense Authorization Act, passed in November 1986, consolidated the existing statutes regarding coal requirements on military bases and revised the U.S. Code (10 U.S.C., sec. 2690). The act stipulated that new heating systems use the most cost-effective fuel. Further, military departments were forbidden to convert heating systems on bases in Europe from coal to oil or any other energy source unless they determined that the conversion is either required by the host country or cost effective over the life cycle of the equipment. Departments must submit notification of conversions to Congress and wait 30 days before proceeding. Older, conflicting provisions were repealed.[63]

Still Not the End

Late in 1986, press reports indicated that the Pentagon would stop shipping U.S. coal to Europe in 1987.[64] The reports were incorrect. At the end of 1987, DoD was still buying U.S. coal, including anthracite, for shipment to its European facilities. Several hundred conversions to district heat have been made—with large savings expected in life-cycle costs—but American forces in Europe maintain hundreds of installations where such conversions are, for various technical and economic reasons, not feasible. The Air Force in particular, because of the remoteness of its bases from cities, has few opportunities to connect to district heating systems. European stockpiles of coal are being drawn down, and shipments from the United States are being reduced. But projections made by the General Accounting Office in August 1987 showed that in 1991 U.S. coal, including some anthra-

[61] *Congressional Record* 132 (8 August 1986, p. S10865).

[62] 100 Stat. 3341-83 (1986) at 3341-117 and 3341-118.

[63] 100 Stat. 3816 (1986) at 3971-72.

[64] "U.S. Bases in Europe to Stop Using Pa. Coal" (1986); "Pentagon Stops Shipping Coal to Overseas Bases" (1986).

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cite, will still be used to heat U.S. bases in Europe.[65] Congress has not repealed the requirement that all coal used by U.S. forces in Europe be U.S. coal; nor is it likely to do so.

In fact, section 8038 of the 1988 Defense Appropriations Act, wrapped into the omnibus Continuing Appropriations Resolution passed in December 1987, reenacts the requirement that DoD use only U.S. coal "when available."[66] The act also prohibits conversion of DoD's European heating plants from coal to oil, natural gas, or district heating, except as provided in 10 U.S.C. 2690.[67] (As indicated above, this section allows a conversion when it is either required by the host country or shown to be cost effective over the life cycle of the equipment, provided that Congress receives a 30-day notice.) These sections of the latest defense appropriations act, along with the reports of insiders, show that industry and congressional supporters of the boondoggle remain active.[68]

So, when the *Wall Street Journal* reported on April 5, 1988, that this year, for the first time since the early 1960s, the Pentagon would ship no anthracite to Germany, one had reason to be suspicious.[69] The report, of course, was not quite accurate. According to Jeffrey Jones, DoD's director of energy policies, some anthracite may be, or may already have been, shipped to Europe in 1988. The Pentagon is attempting to minimize the shipments and plans to feed its European anthracite furnaces from stockpiles already built up in Germany in amounts sufficient to last more than four years.[70] But with or without the shipments, DoD's anthracite problem will continue.

The source of the problem should come as no surprise. Tucked into DoD's 1988 appropriations act, the one folded into the massive omnibus spending bill passed in a mad rush just before Christmas 1987, situated comfortably within a long list of limitation riders, is section 8113, which directs DoD to achieve a rate of domestic coal consumption of 1.6 million tons by fiscal year 1994, including 300,000 tons of anthracite, and to purchase during fiscal year 1988 at least 300,000 tons of anthracite.[71] This provision was not in the House version of the bill. It appeared when Senator Stevens, the subcom-

[65]Author's interview of Jeffrey Jones, 17 November 1987; U.S. General Accounting Office (1987).

[66]101 Stat. 1329-44 (1987) at 1329-69.

[67]101 Stat. 1329-44 at 1329-63, 1329-65, and 1329-85.

[68]Author's interviews of Jeffrey Jones, 17 November 1987 and 18 April 1988; author's interview of member of Representative McDade's staff, 17 November 1987.

[69]Wessel (1988).

[70]Author's interview of Jeffrey Jones, 18 April 1988; Wessel (1988).

[71]101 Stat. 1329-44 at 1329-82.

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mittee chairman, as part of a deal with Pennsylvania's Heinz and Specter, added it to the Senate's bill as it passed through the Defense Appropriations Subcommittee. Once that deal was made, the big deed itself was effectively done, for the whole Senate never voted on the DoD Appropriations Act as such. There were no floor amendments. The whole Senate approved the measure only as part of the gigantic "Christmas-tree" spending resolution of December 22.[72] One would be hard pressed to find a better example of the "hidden ball trick."

So the Pentagon is again purchasing anthracite coal it does not need and does not want, at a cost of more than $20 million per year, for the plain purpose of buying a few votes for a few members of Congress. The Pentagon plans to store the hard coal as close to its source as possible, to save at least some transportation costs, building a pile 20 feet deep over 45 acres of northeastern Pennsylvania, a place already blighted by slag heaps and other scars of its mining past. Senator Gramm says the whole thing is "plain wrong," but he does not represent the hard-coal constituency. Senator Specter makes no apologies. "It is true that this coal is being stockpiled," he admits, "but it will be used."[73] Politically speaking, it already has been, and so have the American taxpayers.

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[72]Author's interview of Bill Morley, legislative assistant to Senator Specter, 25 April 1988.

[73]Wessel (1988); author's interview of Jeffrey Jones, 18 April 1988.

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The Struggle Over Electricity Transmission Access

Kenneth W. Costello

Introduction

Transmission access is one of the most highly debated issues in the electric utility industry. The basic argument centers on property rights: the owner's rights of controlling transmission lines as opposed to the rights of independent suppliers and consumers to engage in trade. Specifically, groups of electricity consumers and nonutility power producers want guaranteed access to transmission facilities, mandatory "wheeling" (see Electricity Consumers Resource Council 1987; Hobart 1987; and National Independent Energy Producers 1987). They seek legislation or regulatory rules that would impose an "obligation to transmit" requirement on transmission system owners. The struggle over transmission access rights has become especially fierce over the last few years. Interest groups have expended substantial resources to persuade legislative, judicial, and regulatory bodies to their point of view.[1]

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[1]Several bills have been introduced in Congress and state legislatures giving users transmission access rights. For example, in late 1987 Rep. Lynn Martin of Illinois introduced legislation that would amend the Federal Power Act to give state public utility commissions the authority to order "intrastate" wheeling and customer wheeling. Over the last 10 years, there have been more than a dozen antitrust cases involving transmission access and more are anticipated (see Pace and Frame 1987, p. 1).

The Federal Energy Regulatory Commission has received numerous comments on transmission access and pricing issues in response to its 1985 Notice of Inquiry on wholesale electricity transactions and transmission policies (Docket No. RM85–17–000). The responders included state public utility commissions; many privately owned utilities and their trade associations; and trade associations of rural electric cooperatives, publicly owned utilities, and industrial customers.

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The electric utility industry strongly opposes these groups' attempts to obtain transmission access rights. The industry argues that unless utilities maintain control over the use of their transmission systems, major technical, economic, and equity problems are likely to arise.[2]

This paper outlines the current struggle over transmission access and identifies its major sources and participants. A theoretical framework is developed to illustrate the magnitude of the maximum "fighting" costs that groups would be willing to incur to preserve the status quo (in the case of electric utilities) or to obtain users' transmission rights (in the case of consumer groups). These costs are compared with the social welfare costs of pricing inefficiencies currently affecting the electric utility industry. Although the analysis assumes stationary demand and cost conditions, it provides a reasonable benchmark of the economic costs associated with the status quo. Numerical examples estimating these economic costs are also presented.

Whether all fighting costs are wasteful (i.e., represent social costs) is a major issue permeating the transmission access debate. For example, costs expended by consumers to obtain wheeling rights so that they can shop for cheaper power may ultimately produce efficiency gains. These gains are shown to be potentially substantial. For purposes of public policy, these gains must be assessed against the costs of reallocating the property rights of the transmission network from utilities to users. After a review of various policy alternatives, the paper concludes that the sizable sums being spent by special-interest groups over transmission access may warrant an immediate response by the Federal Energy Regulatory Commission (FERC). A longer-term solution may require congressional action.

The Current Situation

The electric utility industry is becoming increasingly competitive. The Public Utility Regulatory Policies Act (PURPA) of 1978, rising retail rates, and technological improvements in small-scale generating facilities have improved the economic viability of nonutility power production. Nonutility producers believe they can compete with electric utilities in a true marketplace, but one in which they would have guaranteed transmission access. Without this assurance, nonutility producers fear that they may be deprived of selling their

[2]For example, the Edison Electric Institute (1987, Exhibit D, p. 25) stated to the Federal Energy Regulatory Commission: "Apart from potential adverse impacts from mandatory customer wheeling on system reliability and economic dispatch, which are significant and should not be ignored, the remaining consequence is a shift in dollars between the utility's other customers and the entity gaining such access."

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power in particular markets.[3] Consequently, their ability to obtain necessary capital funding is jeopardized.

Customers with industrial and wholesale requirements have recently found opportunities and incentives to purchase lower-priced power, owing to unprecedented surplus capacity and rate differentials among nearby utilities. Some wholesale customers have successfully switched to other utilities.[4] Industrial customers have threatened to shop for cheaper power, but they are hindered by state public utility statutes granting utilities exclusive franchises for retail services.[5] Both wholesale and industrial customers are pressing for mandatory wheeling (i.e., forcing transmission-network owners to transport electricity from generators under prespecified conditions) to create opportunities to purchase cheaper power.

In response to the increased demand for transmission services by third parties, electric utilities have generally opposed wheeling power to their current customers unless they are required to do so by contractual arrangements or regulatory decisions. The Federal Power Act allows electric utilities the discretion of whether to decline or provide transmission services to third parties.[6] As a result, utilities can deny transmission services to individual parties even when such transactions are economical.

For the electric utility industry, much is at stake, namely, the continuation of de facto exclusive franchises. By allowing retail cus-

[3]In these markets, producers may receive a higher price than they would otherwise. In the extreme case in which a nonutility producer is able to sell only to the local utility, the utility can exercise its monopsony power by offering the producer a below-market price and can purchase less power than is economically efficient.

[4]For example, some Illinois customers with wholesale requirements have been successful in signing contracts with lower-priced utilities or in getting rate concessions from the local utility (see "Four Illinois Munis Extract Rate Breaks from Comm Ed; General Defection a Spur").

[5]Most U.S. electric utilities have de facto exclusive franchises in which they are granted the right to be the sole supplier of electricity in a specified area in return for providing highly reliable service at a reasonable price (e.g., see Ill. Rev. Stat. 1985, ch. 111 2/3, pars. 8-406 and 407). Pace (1987, p. 277) interprets this privilege to include a situation where "if the customer purchases electricity at its present location, it must purchase it exclusively from the franchised or certificated local utility."

[6]Before the 1978 Public Utility Regulatory Policies Act, FERC had no authority to order wheeling. Although PURPA gave FERC explicit authority to order wheeling, this authority is extremely limited. For example, the commission has never ordered involuntary wheeling under PURPA. In addition, FERC has ruled that PURPA did not grant it any authority to mandate wheeling to rectify anticompetitive behavior. The courts also have tended to severely limit FERC's authority over wheeling.

With regard to the ordering of wheeling by states, it appears that the states are preempted by both the supremacy and commerce clauses of the U.S. Constitution (see Illinois Commerce Commission 1987).

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tomers to search for cheaper electricity, transmission access would force utilities to act more like competitive firms, both in controlling their costs and in pricing services according to market conditions.[7] In the short run, present pricing practices, together with transmission access, undoubtedly would result in net revenue losses for utilities with high embedded costs (i.e., with large unamortized capital investment). Utility opposition to transmission access derives from these anticipated losses. These losses can be measured by the inability to recover the full value of sunk costs that would occur under traditional rate-of-return regulation.[8] To avoid such losses, the electric utility industry is likely to expend substantial resources to block any legislation or regulation that would diminish its control of the transmission system.

The present overpricing of electricity to industrial and wholesale customers is a major factor motivating consumers to shop around. This problem stems from several factors: traditional capital recovery accounting, the social contract between utilities and regulators, political considerations, and the monopoly power of local utilities.[9]

Inefficiently high prices have induced industrial customers either to purchase electricity from other suppliers or to generate their own electricity. In either case, the customer may require wheeling services from its local utility. For example, self-generation may produce surplus power that the owner of the facility may want to sell in the

[7]This outcome may also result from bypass induced by self-generation. The efficiency costs typically associated with uneconomical bypass or uneconomical wheeling may therefore be exaggerated when viewed only from a short-term or static perspective.

[8]Under traditional regulation, all prudent capital expenditures are allowed into the rate base where the utility earns a rate of return. If, however, the regulator applies a "used and useful" test to determine what portion of capital should be allowed in the rate base, or if the utility loses customers between rate cases, the utility's shareholders may have to absorb all or a portion of these losses. In the long run, these losses, or at least a portion of them, may be reflected in higher rates to captive customers.

[9]"Overpricing" refers to the standard of economic efficiency. Traditional capital recovery accounting requires too much of the costs of new power plants to be recovered from all customers in the early years and too little in the later years (see Streiter 1982). The social contract between utilities and regulators—that is, the agreement that a utility can recover all "prudent" costs from captive customers—may have protected the utility from imprudent decisions in view of the obvious problems regulators encounter in distinguishing between good and bad management practices. Political considerations, at least from the mid-1970s until recently, have generally favored residential users (see Wenders 1986). Recently, however, price discrimination against industrial customers has subsided with the filings by several utilities of discounted rates for industrial customers. Finally, the monopoly power of local utilities may prevent customers from purchasing electricity from more efficient suppliers. Some of the above factors, of course, can explain why current prices to all customers may be too high.

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wholesale or retail market.[10] Thus, the costs incurred by customers to obtain wheeling rights, in addition to the electric utility industry's reactive costs, should be included in the social cost of overpricing industrial electricity. Utilities would more intensively oppose customer wheeling rights as prices deviate further from marginal costs, since "bypass" would result in larger net revenue losses. The sum of these "fighting" costs is measured in the following section.

In sum, the current struggle over transmission access resembles a "prisoner's dilemma" in which each side is unwilling to compromise and fears that slackening its stance would cause the other side to win. The social costs incurred during such strategies are often substantial and recurring (see Wenders 1987).

Static Analysis

Theoretical Framework

Figure 1 illustrates the case of an industrial customer (or, for that matter, a wholesale customer) who has an incentive to purchase electricity from a nonlocal utility supplier. D is the customer's linear demand schedule for electricity; P_l is the electricity price of the local utility; P_c is the electricity price of a competitive supplier; and MC_l is the local utility's constant marginal cost line. The customer can benefit from buying electricity from the other supplier by area A + B.[11] To gain transmission access, a risk-neutral customer would be willing to spend up to this amount.[12]

Since a customer's chances of gaining access to the transmission network by pressuring legislators or regulators are uncertain, the customer would expend only some portion of his *ex ante* economic benefits from switching suppliers. For industrial customers as a group, expenditures made to gain transmission access would likely be less, and possibly much less, than the level that maximizes their expected economic benefits. This is so because the group is unlikely to act effectively as a cohesive unit in obviating the free-rider problem. In

[10]Third-party wheeling would act to expand the market for surplus self-generated power. Rather than having to sell power only to the local utility—a classic case of a monopsonistic market—transmission access would enable the owner of self-generated power to sell power to those buyers willing to pay the highest prices. Buyers may include nonlocal utilities, retail customers, or another facility owned by the self-generator.

[11]Area A + B represents consumer's surplus under the assumptions that different electricity producers are perfect substitutes and that the income effect is zero; therefore, D measures the customer's Marshallian demand curve for electricity.

[12]See Higgins et al. (1985) for a discussion of the effects of risk preference on rent-seeking costs various groups are willing to incur.

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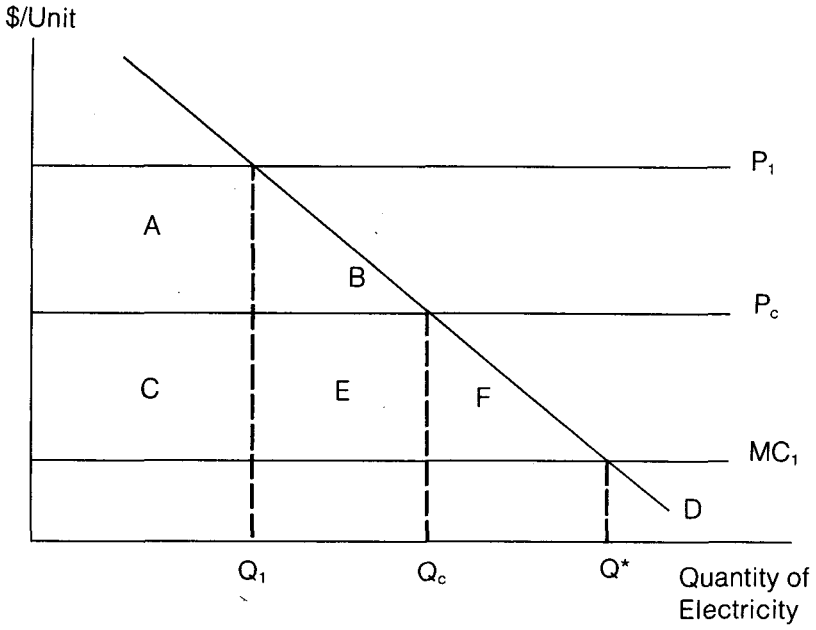
FIGURE 1

STATIC ANALYSIS OF TRANSMISSION ACCESS



other words, some members of the group would reveal little preference for transmission access and would therefore devote few resources to the group's efforts.[13] The free-rider effect would probably be much less for the electric utility industry, since it is highly organized. Consequently, the fighting costs that the industry is willing to incur should correspond closer to the "maximum level" (measured later in this section).

Figure 1 also shows that the local utility's net revenues would decline by area A+C when the customer bypasses the utility for another supplier. The utility's losses are a direct function of the difference between its marginal cost and price, which can be quite large for utilities that are completing high-cost baseload plants. Because these utilities have strong incentives to thwart bypass, they generally would refuse to transmit power purchased by a customer from another supplier. In Figure 1, utilities would be willing to expend a maximum of area A+C to counter efforts by consumers to gain transmission access.

[13]See Baumol and Ordover (1985) for a discussion of how the free-rider problem affects rent-seeking costs.

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The maximum fighting costs are measured by area 2A + B + C. This area is equal to the maximum combined costs incurred by consumer groups to gain transmission access and by electric utilities to maintain voluntary wheeling. These costs may produce no economic efficiency gains, and therefore they represent a social cost of continuing the current right of utilities voluntarily to supply transmission services. In comparison, allocative (pricing) inefficiency, excluding the fighting costs, is measured in Figure 1 as area B + E + F. This area is less than the maximum fighting costs. The probable minimum difference between the two areas is area 2A (see Appendix).

Additional Efficiency Issues

If the electric utility industry is successful in preventing consumers from gaining transmission access, the cumulative fighting costs will have done no more than maintain the status quo. The heart of the current debate is whether this outcome would enhance efficiency, in relation to transmission access proponents winning the fight. If customer transmission access results in a reallocation of electricity production to more cost-efficient suppliers, the status quo may carry a high social cost. On the other hand, requiring utilities to wheel electricity for their present customers may be uneconomical, given existing regulatory pricing procedures. For example, an industrial customer may bypass a local utility in favor of another utility that has higher marginal costs. Many of the new high-cost baseload plants have high prices but low marginal costs. As a result, the prevention of customer wheeling may actually improve economic efficiency, at least over the short run.

One way to avoid uneconomic bypass by customers with transmission access rights is to allow market-based pricing. A utility would then be able to adjust its prices to short-run marginal cost in order to attract or retain customers. According to Figure 1, if the local utility offers a price equal to its marginal cost, MC_1, and loses a customer to another utility, the competing utility must have a lower marginal cost, assuming that all utilities can price as low as their marginal costs. The allocative efficiency gain from the local utility being pressured by competitive forces to offer a marginal cost-based price is measured by area B + E + F. Further, if electricity production is reallocated to more efficient suppliers, productive efficiency would also improve.[14]

[14]Productive efficiency may be improved since the varying prices charged by suppliers would more closely reflect each one's marginal costs. Consequently, the likelihood of customers being supplied by lower-cost producers in a region is greater than when such customers are constrained to purchase their electricity from local utilities at

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So transmission access, accompanied by market-based pricing, may lead to large efficiency gains in the electric utility industry. But if this is the case, why can utilities refuse to transmit power for their customers, and why must utilities generally price their services on the basis of fully distributed costs? Two important reasons come to mind.

First, electric utilities as a group generally oppose disruption of their exclusive franchises and the creation of a truly competitive environment. In a competitive setting, price wars, threats of bankruptcies and mergers, and low profit margins would become more common.[15] For example, in Figure 1, competition may reduce the utility's net revenues by area A + C.

Second, most state public utility commissions and residential consumer groups would be likely to oppose, or at least be reluctant to support, a combined competitive pricing/customer transmission access regime.[16] A commission's main concern would be the economic effect on captive customers when customers switch to other suppliers. Under traditional rate-making practices, a utility's net revenue losses are eventually passed on to its remaining customers in the form of higher rates. This static perspective of competition assumes a zero-sum game in which there would necessarily be winners and losers. Although this assumption would likely hold up in the short run, in the longer run all customers may benefit from a more cost-conscious and price-efficient electric utility industry. But, because these benefits are less immediate and more uncertain than the costs, they would be greatly discounted by regulators and residential consumer groups. The long-run efficiency gains may be much greater than the static gains shown in Figure 1 as area B + E + F. The utility's marginal cost curve may shift downward as the result of competitive forces (induced by open transmission access) pressuring the utility to improve its internal productive efficiencies.

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embedded cost-based rates. In Figure 1, higher productive efficiency can be measured by multiplying the difference between the marginal costs of the local utility and the new supplier by the amount of electricity lost by the local utility.

[15]Electric utilities might be expected to argue that retail customer access to the transmission network, coupled with competitive pricing, would lead to "destructive, cut-throat" competition. This type of argument was favored by the electric utility industry at the beginning of this century in its support of state regulation (Jarrell 1978). The alleged social harm of competition was also an argument often used to support regulatory cartelization of other industries.

[16]State commissions are less opposed to proposals promoting interutility wheeling, because such wheeling would have no expected upward effect on electricity prices and, in the long run, may defer the building of new generating capacity.

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Above all, Figure 1 illustrates that consumers in competitive markets may realize large economic gains from a competitive pricing/transmission access environment. This gain is measured as the trapezoid area bounded by the customer's demand curve, the "noncompetitive" price, P_1, and the local utility's marginal cost line, MC_1. This large gain should stimulate much activity by noncaptive customers to obtain transmission access rights. Since a sizable portion of the gain (area A+C) is extracted from utilities, however, they would try to thwart such efforts.[17]

The total social costs of reform and reactive activities by various interest groups may be substantial. These costs would be magnified if the outcome produces a decline in economic efficiency. For example, under present pricing procedures, if consumer groups succeed in obtaining transmission access, the less efficient utilities may supply additional electricity and the more efficient utilities may supply less. This outcome, which is a claim of the electric utility industry, cannot be disregarded (see Pace and Frame 1987; Illinois Commerce Commission 1987).

As stated above, however, combining transmission access with market-based pricing may greatly improve economic efficiency in the electric utility industry. Therefore, if customers gain transmission access rights that, in turn, provoke competitive pricing, the fighting costs may have a significant efficiency-enhancing effect. The basic argument is that in the absence of transmission access and large-scale bypass, utilities and their regulators would continue to price inefficiently on the basis of embedded costs. But with bypass induced by transmission access, regulation would attempt to protect the captive customers. The most efficient way of doing so would be to allow the utility to compete with other suppliers by offering market-based prices. Opponents of bypass, who argue that permitting customers to choose suppliers would reduce economic efficiency, neglect the likelihood of drastically changed pricing procedures under transmission access. In other words, it is presumed that pricing is unaffected by customers able to buy electricity from nonlocal utilities. Since the deadweight losses from present pricing practices would increase with bypass opportunities, regulators should have greater incentive to modify such practices. This is because deadweight losses reduce potential benefits that regulators can bestow on consumers and producers collectively (see Becker 1983).

[17]Area A+C may eventually be recovered from captive customers in the form of higher rates. Since some of these customers are politically active, the utility's shareholders may ultimately absorb the net revenue losses.

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Numerical Examples

In computing the different areas in Figure 1 on an annual basis, one scenario is presented in which industrial customers of an Illinois utility are able to purchase cheaper electricity from utilities located in adjacent states. Applying actual 1988 data, the Illinois utility charges 5.75 cents per kilowatt-hour (kWh), and other utilities charge, on average, 4.09 cents per kWh (including market transaction costs and transmission charges). The Illinois utility's short-run marginal cost is 2.91 cents per kWh; its sales loss from bypass of industrial customers to other utilities is 10 million megawatt-hours.[18] Finally, it is assumed that the price elasticity of demand for industrial customers is one (in absolute terms). Based on this scenario, area 2A + B + C ("maximum fighting costs") is computed as $474 million, area B + E + F ("allocative inefficiency") as $70 million, and area 2A (the "minimum" difference between the two foregoing areas) as $332 million. These calculations clearly illustrate the maximum fighting costs are large, both in absolute terms and relative to allocative inefficiency.[19] They also imply the potential benefits to be gained from legislative or regulatory action lessening the intensity of the transmission access battle. Furthermore, the calculations show a $284 million loss in net revenue to the Illinois utility and a $190 million gain to industrial customers who switch suppliers.[20]

Three other scenarios, presented below, assume that some industrial customers in northern Illinois, northern Indiana, or both bypass their local utilities and buy their electricity from downstate Illinois utilities belonging to the same power pool. The three scenarios are as follows:

- Scenario A: Surplus electricity from downstate utilities is sold only to northern Illinois industrial customers.
- Scenario B: Surplus power from downstate utilities is sold only to northern Indiana industrial customers.
- Scenario C: Surplus power from downstate utilities is sold to both northern Illinois and northern Indiana industrial customers on the basis of their relative existing industrial demands.

[18]This sales loss represents about one-fourth of the total sales made by Illinois investor-owned utilities to industrial customers.

[19]The estimated maximum fighting costs are almost seven times greater than the dollar value of the allocative inefficiency.

[20]The Illinois utility may earn a profit from providing transmission service and backup service to customers that switched. Utilities currently make little profit from wheeling power to third parties. Wheeling rates generally are based on embedded costs, which utilities claim are below their opportunity costs (National Regulatory Research Institute 1987).

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Table 1 shows the estimated annual economic effect on the various parties affected by the bypass. The net revenue losses to the utilities victimized by bypass are large, and the benefits to the switching customers are likewise large. Furthermore, the efficiency gain for each scenario is substantial: $99.0 million (scenario A), $87.3 million (scenario B), and $88.6 million (scenario C). These gains are a result of electricity being supplied by a lower-cost producer. The maximum fighting costs, representing the sum of the economic losses to the old supplier plus the economic gains to industrial customers, are also large: $422.1 million (scenario A), $454.4 million (scenario B), and $444.5 million (scenario C). It is assumed that the downstate utilities, in spite of their short-term gain, will not lobby or undertake other activities in support of customer wheeling. Such an assumption is reasonable, given the electric utility industry's vigorous opposition to customer wheeling. Individual utilities would likely be reluctant to "buck the industry line."

TABLE 1

ECONOMIC EFFECT OF BYPASS BY INDUSTRIAL CUSTOMERS[a] (IN MILLIONS OF DOLLARS)

Affected Party	Scenario A	Scenario B	Scenario C
Northern Illinois Utility	(255.6)[b]	–	(181.8)
Northern Indiana Utility	–	(277.6)	(90.2)
Downstate Utilities	188.1	188.1	188.1
Illinois Industrial Customers	166.5	–	118.4
Indiana Industrial Customers	–	176.8	54.1
Total[c]	99.0	87.3	88.6

[a]Several assumptions were made for the different parameters: electricity prices = 5.75¢ per kWh (northern Illinois utility), 5.98¢ per kWh (northern Indiana utility), and 3.90¢ per kWh (downstate utilities); short-run marginal costs = 2.91¢ per kWh (northern Illinois utility), 2.51¢ per kWh (northern Indiana utility), and 1.81¢ per kWh (downstate utilities); the potential industrial bypass losses for northern Illinois and northern Indiana utilities are 20×10^6 megawatt-hours (MWhs) and 8×10^6 MWhs, respectively. Finally, the potential market supply by downstate utilities to the northern areas is 9×10^6 MWhs.

[b]The numbers in parentheses represent net revenue losses.

[c]The total dollar amount reflects the efficiency gain associated with each scenario. It equals the net benefit to utilities and industrial customers as a whole.

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Policy Alternatives

The efficiency gains measured in the preceding section do not account for potential costs that may result from reallocating property rights of transmission facilities from owners to users. For example, forced wheeling may jeopardize the reliability and stability of the transmission network (see Edison Electric Institute 1987; Pace and Frame 1987).

In addition, unless forced wheeling legislation and rules developed by regulators are explicit and well-specified, the rights of both owners and potential users would be ambiguous: would transmission owners be required to expand capacity when new demands are imposed; or would owners only have to find space on their existing networks to accommodate demand? If so, would access be conditional on additional wheeling's impact on the stability and reliability of the entire transmission network? Without explicit access rules, utilities face increased uncertainty on how much to expand their transmission capacity. They may be reluctant to invest in new capacity, especially if the prices they received for providing transmission services were below their opportunity costs. In the absence of market-based pricing of transmission services, noneconomic criteria would likely determine who obtains access to the network. Consequently, highest-value users may be denied transmission service because of occupancy by other users.

Forced wheeling may create an additional problem by increasing the external costs of operating the transmission network. Forced wheeling is likely to lower the reliability of electric service to consumers using interconnected utilities.[21] Unless transmission-service prices are adjusted upward to reflect these costs, efficiency losses would result.

Other alternatives that would give consumers and independent power producers increased access to the transmission network may be preferable. Vernon Smith (1987) proposes that unregulated parties can share ownership rights in a transmission line. He argues that this institutional arrangement can provide "competition in the presence of scale economies." Under his proposal, owners would have the

[21]Such use is referred to in the electric utility industry as the parallel path problem, which now occurs regularly. All interconnected utilities encounter the problem but tolerate it as a trade-off for increased reliability and improved transmission efficiencies.

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right either to use their share of a transmission line or to sell (or lease) it to others. Consumers and independent power producers would be able to negotiate with owners for transmission access rights at a compensatory (unregulated) price. Compared with the forced-wheeling option (assuming present regulatory pricing procedures), Smith's proposal would give owners an incentive to expand their transmission capacity and to sell access rights to the highest-value users.

Alternative transmission-access options include vertical disintegration of the electric utility industry, government ownership of transmission facilities, and more efficient pricing of transmission services. Although vertical disintegration may be the preferable long-run solution to the transmission access problem, it has potential problems that at this point are not well understood (see Joskow and Schmalensee 1983; Stelzer 1982).

Government ownership of the transmission network would be plagued with serious problems. First, the government would probably be less efficient than the private sector in operating and expanding transmission facilities. Second, a publicly owned transmission network would more likely set prices for transmission services that are less market oriented and more reflective of the political strengths of various users. Overall, the economic rationale for public ownership of the transmission network is unpersuasive. In the absence of substantial market failure that is uncorrectable by private ownership, little support exists for government ownership.

The "more efficient pricing" option, which is the one being pursued by FERC, seems sensible as a starting point (see Hesse 1988). Present pricing policies give utilities little incentive (and even a disincentive) to provide transmission services to third parties and to expand their transmission capacity (see Illinois Commerce Commission 1987; National Regulatory Research Institute 1987). Some of the present utility opposition to wheeling may dissipate if utilities are given an opportunity to profit from transmitting power for other parties. Flexible pricing of transmission services (e.g., auctioning transmission capacity or allowing prices below stand-above costs) would also allow utilities to quickly vary their prices when market conditions change. Consequently, utilities may offer more transmission services, especially to those users who value these services the most and are therefore willing to pay the highest prices.

Conclusion

Urgent action on transmission access may be warranted. Various interest groups are devoting substantial resources to the issue: con-

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sumer and nonutility groups hope to obtain transmission access, and the electric utility industry hopes to maintain its complete control over the supply of transmission services. Because each side is spending large sums of money, some type of legislative or regulatory compromise balancing the interests of all participants is likely. For example, one policy alternative that may be politically acceptable involves giving nonutility power producers guaranteed transmission access while allowing utilities to earn greater profits from supplying transmission services to third parties.[22]

Under present transmission-service pricing procedures, there is some doubt whether customer access to transmission facilities would improve economic efficiency. The electric utility industry claims that the major economic effect of transmission access would be distributional rather than efficiency enhancing (i.e., "wheeling money") and that the reallocation of property rights would create technical and external-cost problems for transmission systems. On the other hand, continuance of a local utility's monopoly power may stifle competitive forces from creating a more economically efficient electric utility industry. The static analysis showed that the efficiency gains from competition could be substantial. Assessing which side is correct is made difficult by the uncertainty surrounding the economic efficiency effects of each side's proposed course of action.

Although the efficiency effect of transmission access is arguable, the large distributional effect is not. With substantial dollars at stake, both sides of the transmission access issue would likely continue to expend substantial sums of money to sway legislators and regulators to their respective positions. Which side will ultimately prevail is difficult to judge. Because of the concentration of power within the electric utility industry and its high degree of organization, it will be difficult for consumers and nonutility producers groups to gain transmission access rights. There seems to be, however, a political shift toward more competition in the electric utility industry, which would favor consumer and nonutility producers groups.[23]

In any event, politicians are unlikely to quickly resolve the transmission access issue since the potential gains from either side to

[22]The FERC appears to be receptive to market-based transmission service pricing by its approval of the proposed experiment of the Western Systems Power Pool (Docket No. ER87–97–001, 12 March 1987) and the Baltimore Gas and Electric's proposed auctioning of transmission capacity (Docket No. ER87–496–000, 7 August 1987).

[23]This shift is reflected in the increased demand for wheeling (discussed above). The benefits to noncaptive customers from switching suppliers have risen to the point where these customers lobby vigorously for transmission access rights. The FERC appears to be moving toward support of a more competitive electric utility industry (see Federal Energy Regulatory Commission 1987).

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obtain their support are substantial.[24] As a stopgap policy, FERC may have to initiate action to resolve the conflict. Although its authority to order wheeling is currently constrained by the Federal Power Act, FERC can, through its pricing policies, give utilities more pecuniary incentives to accommodate third-party demands for transmission services.[25] FERC can also better specify the conditions under which a utility can refuse to provide transmission services. For example, the commission may require utilities to show that transmission capacity is inadequate (which would be a highly contentious issue) or that technical difficulties would result from transmitting power for a specific party.[26] Since the debate is over property rights, however, any FERC initiative unfavorable to electric utilities may be overturned by congressional or judicial action. Electric utilities would likely conduct an aggressive campaign if FERC were to force them to relinquish control of their transmission network.

As a long-run remedy to the transmission access problem, Smith's proposal seems most attractive. It would (1) enhance competitive conditions by reducing the market power of any one transmission owner; (2) continue existing benefits from economies of scale in transmission; (3) allow property rights to transmission access to be transferred in an efficient manner; (4) encourage owners of transmission lines to make economical investments in new capacity; and (5) define the actual property rights of owners and potential users of transmission lines.

Smith's proposal may make unnecessary much of the fighting costs that are now incurred by special interest groups. There would remain, however, the problem of the existing social contract whereby retail

[24]Proposed wheeling legislation may represent what is sometimes called "milker bills." McChesney (1987) describes milker bills as "legislative proposals intended only to squeeze private producers for payments not to pass the rent-extracting legislation." Because transmission systems constitute large sunk costs, electric utilities are vulnerable to politicians' rent-dissipating efforts. As McChesney points out, politicians have been active participants in the rent-seeking arena.

[25]It should be noted that the electric utility industry has argued that the existing transmission network is being utilized at or near its maximum capacity in many areas of the country. If this is the case, raising transmission prices would be expected, at least in the short run, to have an insignificant effect on the availability of transmission services. Consequently, higher transmission prices would effectively transfer income from the buyer and seller of electricity to the transmitter and thus result in small total economic welfare gains.

[26]Potential users are handicapped because of the information problem in determining independently whether a utility has available transmission capacity. Consequently, utilities are able to prevent economical trading simply by asserting that no transmission capacity is available. Even where forced wheeling is permitted, this problem would still exist.

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consumers are required to purchase their electricity from a local utility. Changes in federal legislation, in addition to those implicit in Smith's proposal, would be needed to give retail consumers the right to choose their electricity suppliers. The benefits from giving retail consumers this right may be substantial.

Appendix

The proof that the maximum fighting costs exceed the welfare cost of allocative inefficiency, at a minimum, by Area 2A is derived below.

First, the difference between the two areas, designated as MFC, is the maximum fighting costs minus allocative inefficiency. It can be written as

$$MFC = 2A + C - E - F.$$

From Figure 1, MFC can be expressed as

$$MFC = 2(P_1 - P_c)\,Q_1 + (P_c - MC_1)\,Q_1 - (P_c - MC_1)\,(Q_c - Q_1) - 1/2\,(P_c - MC_1)\,(Q^* - Q_c).$$

Rearranging the terms, and simplifying,

$$MFC = 2Q_1\,(P_1 - MC_1) - 1/2\,(P_c - MC_1)\,(Q_c + Q^*).$$

Next, setting $Q_c = \frac{e\,Q_1\,(P_1 - P_c)}{P_1} + Q_1$, and

$$Q^* = \frac{e\,Q_1\,(P_1 - MC_1)}{P_1} + Q_1,$$ where e is the

price elasticity of demand in absolute terms, MFC is equal to

$$MFC = 2Q_1\,(P_1 - MC_1) - 1/2\,(P_c - MC_1)\,\frac{eQ_1\,(P_1 - P_c)}{P_1} + Q_1 + \frac{eQ_1\,(P_1 - MC_1)}{P_1} + Q_1,$$

or

$$MFC = 2Q_1\,(P_1 - MC_1) - 1/2\,(P_c - MC_1)\,[2Q_1 + \frac{eQ_1}{P_1}\,(2P_1 - P_c - MC_1)].$$

Assuming e is equal to one, which falls within the range of estimated

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price elasticities for industrial consumers of electricity (Bohi 1981), MFC simplifies to

$$MFC = 2Q_1 (P_1 - MC_1) - 1/2 (P_c - MC_1)$$

$$4Q_1 - \frac{Q_1}{P_1} (P_c + MC_1),$$

or

$$MFC = 2Q_1 (P_1 - P_c) + 1/2\ Q_1 (P_c - MC_1) \left[\frac{1}{P_1} (P_c + MC_1)\right].$$

The first term on the right-hand side is Area 2A in Figure 1. The second term is therefore the residual, or the amount by which MFC exceeds Area 2A.

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Should We Sell the Fed?

William A. Kelly, Jr., Clark Nardinelli, and Myles S. Wallace

Few topics in economics generate more disagreement than the question of monetary policy. No consensus appears to be emerging as more and more theories and proposals appear. Economists disagree over what monetary policy can do and what it should do. Indeed, the debate over monetary policy is often cited by noneconomists as evidence of the confused state of contemporary economics.

We suggest a way out of the confusion. We propose letting the market settle the issue of the proper monetary policy. The government should sell the Federal Reserve System and its power to make monetary policy to the highest bidder. Monetary policy would then be determined through market purchases and sales. Before we explain the details of our proposal, we will discuss some leading current proposals for the conduct of monetary policy.

Some Current Proposals

Discretionary Monetary Policy

Many economists have argued that the Federal Reserve should attempt to moderate the effects of business cycles by engaging in countercyclical monetary policy. The ideal policy response would differ according to circumstances, but it could be expected to be expansionary during recessions and contractionary during inflationary booms. The success of discretionary policy could be judged according to one or more criteria, including the rate of unemployment, the standard deviation of the growth rate of real output, the

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rate of interest, or the rate of inflation. The actual policy target itself can be subject to the discretion of the monetary authorities, changing as circumstances change. For example, depending on the situation, the Federal Reserve might switch from a monetary target to an interest rate target (Poole 1970).

A Monetary Rule

Milton Friedman (1968) put forth the most famous proposal for a monetary rule: the quantity of money (however defined) should be allowed to grow at a constant rate (say 3 to 5 percent) year in and year out. Under this plan, the Federal Reserve Board could be replaced by a computer. The constant growth rule, it should be noted, does embody an automatic countercyclical response. When economic growth is sluggish, the monetary expansion will be more rapid than economic growth, pulling up growth rates. When economic growth is rapid, the expansion of the economy is greater than the monetary growth rate, and monetary policy dampens things a bit. Although Friedman's constant growth rate is the most famous example of a monetary rule, there are others. For example, in a simple rational expectations model (Sargent and Wallace 1976) all known monetary rules are equally effective in reducing the variance of real output caused by unanticipated policy. The advantage of such rules is that they are known to all and are automatic; the rule replaces the discretion of authorities. Although the rule will not eliminate all macroeconomic problems, supporters argue that the rules perform better than the misguided interventions of authorities. The superiority of rules arises because of authorities' ignorance of the short-term timing and magnitude of the effects of monetary policy or because policymakers face incentives to follow inconsistent policies (Kydland and Prescott 1977).

A Gold or Other Commodity Standard

Many economists believe that the basic problem may be fiat money itself. With fiat money, only the authorities have the ability to limit the growth of the money supply. Rules can always be changed. With a paper currency tied to gold, an excessive monetary expansion will cause holders of paper to convert it into gold. The gold drain will force the government to slow down the rate of monetary expansion in order to restore the value of the currency and stem the outflow. The gold (or some other) standard thus provides the discipline to prevent wide swings in the value of the currency. A mild countercyclical response would perhaps exist with such a policy; its main

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advantage is that authorities do not have the power to destabilize the economy under a commodity standard.[1]

Denationalization of Money

One proposal that appears to be gaining strength in Hayek's (1978) argument that money should be denationalized. The proposal amounts to ending the government's legal monopoly of currency issue and allowing free competition. If, for example, private banks begin to issue their own money, competition will force the banks to maintain its value. The force of competition, then, will automatically impart stability to the economy. There is some debate over the specifics of free banking. Greenfield and Yeager (1983) proposed severing the tie between the unit of account and the means of exchange in a free banking system. Whatever the specifics, the common element in proposals for denationalization is the belief that competition outperforms government-sponsored monopoly.

Current Federal Reserve Policy

The Federal Reserve sets policy targets in light of the current and expected future states of the economy. But the decisions made that guide policy and the actual policy are not easy to fathom. Since October 1979, the Fed has officially based monetary policy on targets for monetary aggregates. In recent years, the Fed appears to have abandoned the target approach with respect to M1; the growth of M1 is often well above or below the target range. Policy now appears to be some (occasionally erratic) combination of setting targets for the monetary aggregates, M2 and M3, and influencing interest rates.

Although our list of major proposals and actual policies is not exhaustive, it should be sufficient to demonstrate that numerous proposals for the proper conduct of monetary policy vie for support in political and intellectual marketplaces. Moreover, the proposals are so dissimilar as to create the impression among laymen that economists do little more than argue. The differences in policy proposals, however, do not for the most part reflect differences in goals. All of the proposals aim at increasing economic stability, which in turn should increase consumer welfare and may increase long-run economic growth. Welfare, stability, and growth, then, are the goals. It should be possible, therefore, to eventually find the optimal policy through trial and error. Accumulated historical experience ought to be moving policy in the right direction, as mistaken policies are tried

[1]For a recent proposal to return to the gold standard, see Mundell (1981).

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and then abandoned. Such a belief, however, neglects the problem of incentives.

The Problem of Incentives

In a remarkable article, Milton Friedman (1986, p. 2) confessed that the time he has spent attempting "to persuade the Federal Reserve System that it was doing the wrong thing and that it ought to adopt a different policy . . . was time ill-spent." Friedman was not abandoning his belief that a monetary rule would work better than alternative monetary policies. He was acknowledging that, as the public choice theorists argue, public officials are like other people: They operate in their own self-interest. The chairman of the Federal Reserve Board has been called the second most powerful man in America, the adoption of Friedman's monetary rule—or, for that matter, *any* rule—would strip the chairman of discretionary power. It would be difficult for any public official to accept the proposition that some automatic system or computer could do a better job than he is doing. That tendency, mingled with the natural desire for power, militates against any member of the Federal Reserve Board choosing rules over discretion.

The problem with current policy is that the system's incentives are such that only those who believe in an activist policy are likely to end up on the Federal Reserve Board. Anyone qualified to serve on the board could earn far more in the private sector, and most board members take substantial cuts in pay when they join the board. If income is not the reward, then it must be the power, prestige, and influence attached to the position. Furthermore, the men and women attracted to the job are those who place a relatively high value on power and prestige. A banker whose principal goal is to maximize personal income is not likely to be interested in serving on the Federal Reserve Board. The current system, then, is biased toward activism because only activists will be attracted to the job.

It might appear that the bias toward activism would be no problem if activism were always the correct policy. But even granting the necessity for some activist policy, a problem still exists. Many different activist policies compete for public support and the Board's adoption, and choosing the correct policy might be made more difficult if questions of power influence the choice. The degree of activism that is optimal for the economy may differ from the degree of activism that is optimal for the monetary authorities. These conflicts will not always be resolved in favor of the economy.

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It would be a gross misstatement to say that the performance of the economy does not matter to the monetary authorities. It obviously matters a great deal. No Federal Reserve official would willingly plunge the economy into recession in order to increase his or her power or prestige. Moreover, such temptations are not likely to exist, because poor economic performance tends to reduce the prestige of the Fed and bring about calls for a reduction in its power. The Fed, then, does not have unlimited, arbitrary power. Its general policies must not be too harmful to the economy; this constraint forces a certain amount of conservatism on the system. At the margin, however, there remain many choices to be made, and there is no mechanism to ensure that these choices are generally correct. The incentive structure may work to reduce the probability of disastrous missteps, but monetary policy may always limp along at something less than optimal. Recessions might be a little deeper or a little more frequent than they would be if those who made monetary policy bore the full consequence of their mistakes. As things stand, neither the chairman nor the board members can be removed. Although the president who appoints the members of an unsuccessful Federal Reserve Board might face political consequences, this check operates with a long and uncertain lag.

Current incentives, then, probably prevent disastrous mistakes while allowing or perhaps even encouraging small mistakes in monetary policy. If, as Friedman concluded, persuasion is largely a waste of time, what is to be done?

Selling the Fed

We suggest a remedy that forces the public and private interests to coincide. Specifically, we propose to sever the tie between the federal government and the Federal Reserve System by selling the Fed in the open market. The new Fed, however, would not be run as a typical profit-maximizing private bank. Rather, the profits of the private Fed are to be in the form of payments from the federal government. The payments in turn would be tied to the nation's economic performance. If the economy performed well, the Fed would receive a large payment from the Treasury; if the economy performed poorly, the Fed would receive a small payment from the Treasury. The owners of the Fed would have a direct financial incentive to find and adopt policies that lead to optimal macroeconomic performance.

We propose that the Fed and its power to control monetary policy be sold to the general public as a stock issue. The stock could be sold

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through one of the major investment bankers or issued directly to all or part of the citizenry. The certificates could be re-sold at any time. Whatever the methods of original stock issue, the final outcome should be the same. In the end, the Federal Reserve will belong to those who are willing to pay the most for it. The method of original issue could have budgetary and distributional effects, but it should not have a significant effect on the final pattern of ownership.

The payments to the now-private Fed would be financed by tax revenues. They could be contingent on the economy reaching a certain level of performance and will always be directly related to performance, increasing as performance improves. The transfers from the Treasury to the Fed, therefore, would not represent a net revenue drain but would be part of the surplus generated by proper monetary policy.

The attraction of our plan stems from the change in the location of the debates over monetary policy. Debates would be moved away from academic journals, newspapers, and congressional hearings and into the market. Instead of vying for academic honors and political influence, proponents of alternative views will be forced to subject their views to the market test. If an economist has a better method of conducting monetary policy, then a corporation could gain profits by buying a controlling share in the Fed and instituting the policy. For example, suppose a monetary rule is in effect. If successful, the payments by the Treasury to the corporation increase and the price of stock in the Fed rises. Suppose, however, that the policy does not prove successful. If revenues earned by the Fed fall and the stock price falls, then the Fed is fair game for a corporate takeover.[2] Advocates of the gold standard could mount a takeover bid and institute their policy. If successful, the price of stock will rise and the policy will stay in place. If unsuccessful, the stock will fall in price and another takeover (and policy change) will become likely. Under this system, no unsuccessful policy can survive. Furthermore, as new knowledge leads to new ideas in policy, the market mechanism creates a relatively efficient way for new policies to be adopted. The long march from academic idea to popular approval to governmental adoption can be replaced by the quick implementation of new ideas by corporations seeking profits.

Current institutional constraints on the Fed's behavior would be removed under our proposal. The private Fed would have complete control over monetary policy. If the Fed chose to stop printing money and allow competitive monies, it could do so. The Fed could also

[2]Our plan would not allow anti-takeover measures, such as poison pills.

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continue to issue money and allow private monies as well, with Federal Reserve notes serving as the unit of account. All three current policy instruments—the reserve ratio, the discount rate, and open-market operations—could be used in any way the Fed chose.

Our plan does not prevent the Fed from continuing to operate as it does today. The purchasers of the Fed could retain Alan Greenspan as chairman and tell him to carry on as before. Our plan also makes greater political control of the Fed possible. Nothing prevents supporters of the president from purchasing the Fed and operating it according to the president's directions. Those who believe that the president should have this power could purchase control of the Fed and subject their belief to the market test. Someone could even purchase the Fed and subject it to the control of Congress.

The possible sources of the Fed's policy, of course, would not be limited to politicians. Indeed, the battle for control of stock in the Fed might evolve into a battle of competing economists. A corporation could be formed to buy the Fed and implement the policies prescribed by, say, Milton Friedman; another corporation might espouse the theories of James Tobin. It is possible that a corporation could be formed to try the policies of some economist from the past, such as John Maynard Keynes. The debate between supporters of various economists could thus be settled by the market.

Many other differences could emerge in the competitive bidding for control of monetary policy. Whatever the debate, the market will settle it. Success or failure will be registered in the rise or fall of the price of stock in the Fed. What the Fed can and cannot do will also be reflected in the price of its stock. This reflection leads us to a major problem we have yet to confront. What is the basis to be for the payments to the Fed? In other words, what will constitute a successful policy?

The Problem of Success Criteria

Our proposal calls for the new Fed to be compensated according to the economic performance of the economy. The problem is to choose the proper criteria for measuring the success of monetary policy. Some economists believe that monetary policy can affect real output in both the short and the long run. Others believe that money can affect real variables in the short run only. Yet another group believes that anticipated monetary policies have neither short-run nor long-run effects on real variables.

More agreement is to be found when economists discuss the relationship between money and inflation. Practically all American econ-

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omists believe that the rate of growth of the money supply has *some* effect on the rate of inflation. To some economists, inflation is always a monetary phenomenon. To others, money is merely one—and perhaps not the most important—of a host of factors that can cause inflation.

The same disagreements over the effects of monetary policy on real output and the price level arise with other performance criteria, such as the rate of interest. Such disagreements mean that no single criterion can be adopted as our measure of the success or failure of monetary policy. If, for example, the payoff to the owners of the Fed were based on its ability to raise the growth rate of real output above its long-run average, those who believe that monetary policy cannot accomplish such a feat would not bid for the Fed. Similarly, those who believe that money has little effect on the price level would bid very little for the Fed if the payoff to the owners was based entirely on the rate of inflation.

It is highly desirable that groups holding different beliefs about monetary policy should have an incentive to bid for the Fed, and the bidding itself should reveal the strength of these beliefs. In order to encourage those with differing perspectives on macroeconomic policy to bid for the Fed, we suggest multiple performance criteria. The payoff to the owners of the Fed could be based on a weighted average of the following: (1) growth rate of real GNP; (2) rate of inflation; (3) standard deviation of the growth rate of real GNP; and (4) nominal rate of interest.

The numerical measures of success or failure can be determined empirically, perhaps by considering the historical performance of the economy. Although we are not wedded to the four criteria listed above, either this or a similar alternative list is necessary to ensure that a variety of beliefs will be represented in the market for control of monetary policy. Factors other than monetary policy will obviously affect the economy and the resulting payoff to the Fed. The purchase price of the Fed should reflect the degree of anticipated control over economic growth, inflation, stability, and rates of interest (see our discussion of fiscal policy in the next section).

The payoff to the owners of the Fed could be based on the following formula: Payoff = Operating cost + β $(X - \bar{X})$, where X is the performance index and $\bar{X}$ is the historical average of the performance index. For the growth rate of GNP, the payoff coefficient would be positive. The payoff coefficient would be negative for inflation, the nominal rate of interest, and fluctuations in the growth rate of GNP. The allowance for operating costs is to ensure that the payoff will cover costs (and bids for the Fed will be made). If the cost allowance

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is set too high, the purchase price of the Fed should rise to eliminate potential rents.

Once the payoff criteria have been set, modifications should be made only with the greatest of care. Otherwise, the owners of monetary policy would have substantial incentives to lobby for changes in the payoff matrix that would increase revenue. If the lobbying were successful, the owners would reap windfall gains. Similarly, politicians trying to earn political capital have incentives to periodically change the rules of the game, creating windfall gains or losses for the Fed's stockholders. The solution that suggests itself is that the criteria and the monetary payoffs for meeting these criteria should be established on a permanent basis, perhaps in the form of a constitutional amendment. Such a law would allow some limited flexibility for changing circumstances but would substantially increase the difficulty and costs of constant tinkering. The law would also protect owners of the Fed from capricious rule changes by Congress. That is, Congress, preferably through a constitutional amendment, must still set the goals of monetary policy. Our proposal is aimed at creating incentives so that the private goals of the policy-makers at the Federal Reserve will coincide with the public goals in choosing the best possible technical means of meeting those goals.

Possible Objections to the Proposal

Many objections will be raised against the proposal to sell the Fed and the conduct of monetary policy, so we will attempt to anticipate some of them.

1. *Monetary policy could be purchased by some wealthy crank who will then destroy the economy with crackpot policies.* The check against such an occurrence is that the payoff to a successful policy will be high enough to preclude purchase by any individual. The present value of the returns to successful monetary policy will be in the billions. For example, payment for an average level of performance could be set in the neighborhood of $1 billion per year (with substantially higher payments for above average performance). If the Fed were capitalized at 10 percent, its stock would be worth $10 billion.[3] This necessitates a large number of investors and prevents any single individual from having sufficient wealth to purchase the Fed outright.

[3]One billion dollars a year, or $3 billion, or even $10 billion in a $3 trillion economy seems a small cost to create an incentive structure that would produce the monetary policy generating the greatest possible levels of stability and growth.

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There is the possibility of a large number of investors banding together to support some crank. The market, however, provides a quick check. A truly bizarre monetary policy would cause the price of stock to plunge, quickly leading to a takeover by investors who backed a more credible policy. The check on cranks, then, comes from the same market forces that prevent someone's buying IBM and converting its plants to manufacture electronic toothbrushes.

One problem remains. If a crank or group of cranks purchases the Fed and conducts a disastrous monetary policy, the damage to the economy could be enormous and would probably dwarf the private losses of the Fed's owners. We admit this possibility, but a crank could also be inadvertently appointed under the current system. Moreover, a political appointee may be more difficult to remove than a private manager.

2. *The price of stock in the Federal Reserve could be excessively volatile.* Some financial economists (Schiller 1981) hold that stock prices are excessively volatile relative to the stream of earnings. In other words, small changes in performances as measured by earnings often lead to extremely large swings in stock prices. The relevance of excessive volatility to our proposal is that small declines in performance might cause large declines in the price of Fed stock. A management change could then occur as the result of a takeover that was not justified on grounds of poor performance. The excess volatility of stock prices, then, could lead to excess volatility in monetary policy.

There are two counter-arguments to this argument. First, Flavin (1983) has argued that stock prices are not excessively volatile, so the issue remains in doubt. Second, even if stocks are excessively volatile with respect to the "underlying fundamentals," stock volatility is probably no greater than political volatility. Continuity and stability have not been the hallmarks of the history of monetary policy. The political swings of the electorate will produce changes in monetary policy under the current system. The stock price of the Fed could be excessively volatile in the short run, but will reflect performance in the long run. No such guarantee exists under the political control of monetary policy.

3. *A foreign power could purchase monetary policy and purposely use it to cripple the American economy.* Such an occurrence is unlikely for many reasons. First, a foreign power would find the acquisition to be quite expensive, particularly because it would have to be arranged through a third party (assuming that foreign governments would not be allowed to purchase stock directly). Second, it is not clear that crippling the American economy is in the best interest of any foreign

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powers. Third, the danger is only slightly greater than under current conditions. Purchasing one or more leading corporations today and deliberately mismanaging them could cause severe damage to the economy. Whatever checks prevent hostile foreign purchases today—e.g., SEC and FTC rules—would continue to operate for the protection of a Federal Reserve, whose stock could be freely purchased and sold in the market.

Although we believe these checks would be sufficient to prevent hostile ownership of the Fed, some commentators are less sanguine. As an additional safeguard, we are not averse to giving the SEC (or some other agency) the power to void any sale of Fed stock that may jeopardize national security.

If we ignore for the moment the problem of overtly hostile foreign purchase, it is not clear that a private Fed should exclude foreign ownership. If the Fed performs better under foreign ownership, then the American economy benefits. Moreover, if one takes a broader view, it is possible that the optimal organization of the Fed is as a multinational corporation. Foreign subsidiaries would be responsible for foreign money supplies. Coordination of world monetary policies could lead to gains for all nations represented in the corporation. A multinational Fed could solve such vexing problems as the determination of optimum currency areas and the relative merits of fixed and floating exchange rates. The market price of the shares of the multinational Fed would reflect the success or failure of various international monetary policies. Consideration of these and other international issues, however, is beyond our scope here.

4. *Monetary policy is not effective without a responsible fiscal policy.* If economic performance is affected by monetary policy, fiscal policy, and regulations, then the payoff to the Fed will be affected by something it cannot control: the tax and expenditure policies of the federal government. Moreover, the necessities of financing the federal debt and continuing deficits could greatly reduce the degrees of freedom allowed the Fed in operating monetary policy.

This objection is important, but it does not reduce the attractiveness of the proposal. If the performance of the economy is lowered by irresponsible fiscal policy—in spite of responsible monetary policy—the price of Fed stock will reflect the Fed's limited powers. At the lower price, investors will have an incentive to purchase monetary policy and use it to improve the performance of the economy. Even if events are dominated by fiscal policy, good monetary policy is preferable to bad monetary policy.

The importance of fiscal policy suggests other counter-arguments. For example, if fiscal and monetary policy cannot be effective inde-

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pendently, then perhaps the Fed should purchase them both. We see no inherent reason why both monetary and fiscal policy should not be sold. Indeed, selling both would be a way to determine if control of both is necessary to affect economic performance. If monetary and fiscal policy must work together to be effective, then stock in a corporation that controlled both would be worth more than the sum of the stock of two different corporations that controlled them separately. In such circumstances, a single corporation would end up controlling both. If monetary and fiscal policy can be operated effectively and independently, then comparative advantage is likely to lead to control of each by a separate corporation. Indeed, if fiscal and monetary policy are partly related and partly independent, a working relationship between the two could be worked out by the two corporations, e.g., some joint ventures or perhaps a jointly owned subsidiary. In sum, the market can answer the question of the relationship between monetary and fiscal policy and create firms that take account of that relationship, whatever it is.[4]

5. *The purchaser of the Fed could set monetary policy for some goal other than that selected by the political process.* For example, a financial institution with large bond holdings could purchase the Fed and use monetary policy to affect bond prices. In some instances, the goals of the firm will coincide with the public interest; in others they will not. The possibility arises, then, that a firm will purchase the Fed and use monetary policy for private benefit but public harm.

We do not believe that this problem could arise. For one thing, the firm must pay for poor macroeconomic results. The gain on its portfolio must be very large to offset this loss—particularly since we envision large payoffs to the successful management of the Fed. Also, portfolio gains are one-time in nature, but gains from successful operation of the Fed are continuous. The firm that intended to use the Fed to effect a one-time increase in the value of its portfolio would be bidding against firms seeking to purchase a lucrative perpetuity. The firms seeking the perpetuity would surely out-bid other firms most, if not all, of the time. Those rare cases where the firm seeking portfolio-enhancement won would be short-lived, because such firms would be ripe for takeovers.

The fact that Fed policy could be controlled by the president or Congress raises the possibility of political business cycles. A group of investors who are political supporters of the president could pur-

[4]We are not, however, advocating any particular approach to fiscal policy. Other proposals for changes in fiscal policy could be compatible with our proposal for monetary policy.

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chase the Fed and use monetary policy in an attempt to initiate a cyclical boom on the eve of an election. Opponents of the president could purchase monetary policy in order to initiate a recession on the eve of an election. Either policy is unlikely under our proposal. It would be extraordinarily expensive to the new shareholders if the policy did in fact prove harmful to the economy.[5] Even more important, the adoption of our proposal would cut the political link between the effects of monetary policy and the president. Why would the president be praised or blamed for the effects of monetary policy if it is well-known that the office of the president has no control over monetary policy? Furthermore, the public does not have to wait for an election to change the control of monetary policy. If monetary policy is unsatisfactory, the price of stock in the Fed will drop, leading to a takeover. If the president or his supporters should purchase control of the Fed, the performance of the economy would still be judged in the market, not at the polls. Any attempt by the president to manipulate the economy for political advantage would cause the value of stock in the Fed to fall, quickly ending presidential control over monetary policy. Presidents, in common with other potential owners, must design monetary policy so as to maximize the long-run performance of the economy or else lose the Fed to new ownership. The political business cycle, therefore, is far less likely under our proposal than under the current system.

6. *Proper incentives could be created if we simply provide incentive pay to current members of the Federal Reserve Board.* For example, Morgan Reynolds (1980) has suggested that the Board of Governors be paid on a sliding scale, depending on the level of inflation. This plan addresses the problem of incentives, but it has two shortcomings. First, current members of the Board (who have 12-year terms) have generally been attracted to the job more for power and prestige than for income. Hence, they may be less responsive to these types of incentives than others who would seek the job of determining monetary policy. Second, the plan does not allow for takeovers by groups who think they can do a better job and are ready to subject their efforts and ideas to the market test.

Conclusion

We have presented a proposal to allow the market to choose the proper monetary policy. Although we do not explicitly favor a partic-

[5]Although presidential elections themselves are expensive, costing several hundred million dollars, the value of Fed stock under our proposal would be far more expensive—up to many billions of dollars.

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ular policy, by leaving the question up to the market we implicitly adopt the view that markets work. The range of policies that could be adopted under the regime we propose is thus only a subset of all possible policies, due to the exclusion of policies based on nonmarket criteria of success. We note the limit our market orientation imposes on policy choices.

We also recognize that our proposal will not win immediate acceptance. In conversations with other economists, we have found our proposal labeled "crazy" or "too wild." Yet, as we have demonstrated, we have not found any compelling objections to our proposal. Once the novelty wears off, the simple logic of the market solution becomes clear. By putting forth our proposal we hope to introduce a new option into the debate over monetary policy, an option that may not be adopted today but at least will be available for some tomorrow when political and economic conditions make it possible.

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An Institutional Explanation for Corruption of Criminal Justice Officials

Bruce L. Benson

Introduction

Even a very limited sampling of headlines from news magazines over the last several years about instances of corruption by police, prosecutors, and judges illustrates the magnitude of corruption among law enforcement officials. For example: "A True Prince of the City: In Chicago, A Cop Goes Underground to Crack a Police Dope Ring" (*Time*, 26 July 1982, p. 17); "Corruption Is Still a Fact of Life" (*U.S. News & World Report*, November 1982, p. 46); "The Trouble with Harry: A Federal Judge Goes on Trial in Nevada on Bribery Charges" (*Time*, 2 April 1984, p. 64); "The Real Miami Vice?" (*Newsweek*, 11 November 1985, p. 32); and "Passing Judgment on the Judges: A Spate of Legal Troubles in the Judiciary" (*Time*, 20 January 1986, p. 66). This list only touches the surface; after all, these are only some of the officials who got caught. Even if a similar number of crimes by public officials were cleared by arrest as crimes in general (roughly 20 percent of reported crimes and perhaps less than 10 percent of all crimes), the total level of corruption would be substantial. But there are several reasons to believe that the crimes that public officials commit are considerably less likely to be reported (exposed) than private sector crime.

Corruption by law enforcement officials is actually a black market for the property rights over which those officials have been given

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The author is Professor of Economics at Florida State University. This paper draws from his forthcoming book *Liberty and Justice: Alternatives to Government Production of Law and Order*, supported by the Pacific Institute for Public Policy Research.

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discretionary allocative power (Benson 1981a).[1] Rather than assigning rights to reflect political demands, rights are sold to the highest bidder. Police, judges, and prosecutors are not monitored closely, so self-interest may dominate. In order to get some idea of the level of corruption in law enforcement, we must therefore examine the opportunities for corruption and the institutionalized incentives to carry out corrupt acts that face public sector law enforcement officials.

Opportunities for Corruption

Corruption is a consequence of discretionary authority by government officials, and criminal law enforcement officials often have tremendous discretionary power. They have this discretion because of the "commons" problem. Legislatures, courts, and police are like any other public (or commonly held) property. When ownership rights are not assigned to a good or resource and prices are not charged to ration its use, the resource is inefficiently used. Typical examples of the "tragedy of the commons" include the near extinction of the buffalo and the whale as well as the crowding of, littering on, and rapid deterioration of public parks, beaches, roadsides, and waterways. The same incentives apply to law enforcement services (Benson 1988, 1989; Neely 1983).

Blumberg argued that approximately 80 percent of police resources are used up in what he refers to as "social-worker, caretaker, babysitter, errand-boy" activities (1970, p. 185). Many of these activities generate benefits that are concentrated on individuals, but because individuals do not bear the full cost, they tend to overuse the services. Police services are frequently allocated on a first-call, first-served basis. It is doubtful that people would be as quick to call the police to handle minor annoyances if they were responsible for the full cost of the resources (police officers' time, vehicle use, etc.) used. More significantly, there often can be substantial negative externalities arising from using police services to solve minor problems, because police occupied with such tasks are unavailable for far more valuable uses.

Similar problems arise with public courts. Judge Richard Neely (1982, p. 191) noted, for instance, that "while courts often appear free to the casual observer because the court itself is a public facility, courts are actually very expensive." He also explained that "because

[1]Several of the theoretical issues discussed below were explored in Benson (1981a, 1987, 1988) and Benson and Baden (1985). This paper draws freely from these articles, extends them considerably, and applies the analyses in an examination of corruption specific to the criminal law enforcement process.

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the courts are available free of charge they are overused, and the result is justice-defying delays" (p. 164). Such congestion (rationing by waiting) is the typical consequence of common pool resources.

When common pool congestion problems arise, public law enforcement bureaucrats have tremendous discretion in the allocation (rationing) of limited bureau resources among competing demands. As Bent (1974, pp. 3–6) noted:

> With upwards of 30,000 federal, state, and local statutes to uphold, the average policeman is faced with a monumental task of applying these laws evenly. . . . Theoretically the multiplicity of laws may be construed as a traditional administrative device to define conditions of illegal or disorderly behavior that the policeman may encounter, thereby precluding any discretionary responsibility on the part of the individual police officer. In actuality, however, the overload of statutes has made impractical the mechanical application of law by police. Instead, this overload invites the influence of prejudices of individual police officers . . . resulting in the law being administered unevenly and selectively. . . .

With such discretion, police can choose which laws to enforce and which not to enforce. According to Neely (1982, p. 131): "[O]ne's chances of police protection [corresponds] closely to one's position in the geography of political power. . . . More time is devoted to investigating a barroom murder at Second Avenue and Sixty-Third Street [in New York] than to a comparable incident in the South Bronx."

Commons problems in the courts generate considerable discretion for prosecutors and judges. Court time is to a large extent rationed by waiting time, but prosecutors can also ration court time by deciding which cases to prosecute and which to plea bargain; judges similarly decide which cases deserve consideration and which do not. "The point is frequently made as a tribute to our society that ours is a government of laws and not of men. Yet the decision regarding . . . the disposition of each case [is] entirely within the discretion of the prosecuting attorney in the first instance and the judge later on" (Neely 1982, p. 91). Such discretion creates opportunities for corruption.

For instance, in cases where government has modified a rights structure to prevent a competitive market allocation of resources and, consequently, has created the potential for rent extraction for anyone willing to develop an illegal market, the potential illegal transaction (rights modification) can often be easily detected (Benson 1981a). Consequently, the high risk to private individuals prevents participation in an underground market unless the transaction can be made

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to *appear* legal or unless officials who have the discretionary authority to enforce the law agree not to do so. This may be because the property involved is highly visible, so that a change in use or user can be easily detected. Perhaps the property is durable and immobile (e.g., land subject to zoning or other use restrictions, or building codes, liquor license requirements, or operating hours for bars). Under such circumstances, an illegal property rights modification must be accomplished through the actions of a government official. Public officials are in a position to extract rents from illegal market transactions. As a consequence, for example, land use and building regulations appear to generate considerable opportunities for political corruption (Gardiner and Lyman 1978). Corruption in these cases need not go as far as outright changes in statutes or regulations; public officials may simply be induced to ignore violations or to make it easy for certain individuals (but perhaps not their competition) to ease their way through the red tape. The Knapp Commission to Investigate Alleged Police Corruption in New York City (Knapp 1972, p. 68) discovered that the second largest source of police corruption (organized crime was first) was

> legitimate business seeking to ease its way through the maze of City ordinances and regulations. Major offenders are construction contractors and subcontractors, liquor licensees, and managers of businesses like trucking firms and parking lots, which are likely to park large numbers of vehicles illegally. If the police were completely honest, it is likely that members of these groups would seek to corrupt them, since most seem to feel that paying off the police is easier and cheaper than obeying the laws or paying fines and answering summonses when they do violate the laws.

Payoffs came from bars wishing to remain open after hours, from unlicensed liquor establishments, and so on. Judges and prosecutors also have considerable potential in this regard, and unless they are closely monitored, they can drop charges or reach unwarranted verdicts.

There is a closely related opportunity for corruption that has clear and direct applications to criminal law enforcement. In instances where illegal activities in the private sector (e.g., gambling and prostitution) could be prevented or severely limited through relatively inexpensive enforcement efforts, the public officials designated to prevent such activities are given discretion over a very valuable set of property rights that may be sold. These officials can allow certain individuals or groups to operate in the illegal market while preventing other potential participants from entering the market. In other words, they can sell monopoly rights to operate in a private sector underground market and then enforce that rights allocation.

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Schelling (1971) argued that organized crime is really monopolized crime, and Rubin (1979) and Anderson (1979) contended that criminal firms possess market power because there are economies of scale in buying corruption from police and other governmental officials. Demsetz (1968), however, explained that economies of scale are not sufficient for such monopoly pricing. Exploiting a monopoly position requires entry restrictions, typically arising from governmental policy. In the case of underground markets, all entry is illegal; but if enforcement is easy, corrupt public officials can sell the right to extract monopoly rents to selected illegal firms. In this instance, an underground market for governmentally controlled property rights may be required for a private sector underground market to operate. It should not be surprising, then, that the Knapp Commission (1972, p. 68) discovered that

> organized crime is the single biggest source of police corruption through its control of the City's gambling, narcotics, loansharking, and illegal sex-related enterprises like homosexual afterhours bars and pornography, all of which the Department considers to be mob-run. These endeavors are so highly lucrative that large payments to the police are considered a good investment if they protect the business from undue police interference.

Similarly, Ashman (1973, p. 11) contended that "organized crime cannot function without organized justice." He discussed nine judges shown to be on the payroll of crime organizations between 1958 and 1972 and wondered "how many more are still to be discovered" (p. 12).

The potential for corrupt use of police or judicial discretionary power extends well beyond the acceptance of money offered for protection or other favors. Criminals caught in the act may attempt to bribe or face extortion by a police officer. The Knapp Commission (1972, p. 69) reported "two smaller sources of payments to the police are private citizens, like motorists caught breaking the law, and small time criminals like gypsy fortune tellers, purse-snatchers, and pick pockets who may attempt to buy their freedom from an arresting officer." Police, judges, and other public officials control who is arrested, charged, and convicted, as well as the nature of the punishment. They are, therefore, in a position to sell the right not to be arrested, charged, or convicted, and the right to avoid severe punishment.[2]

[2]Public officials in a position to control entry into illegal markets can actually go beyond simply accepting bribes to protect a particular private sector organization. Some may be bold enough to enter the market themselves. Prison officials, for example, are in an

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The potential for corruption in law enforcement arises for precisely the same reason that underground private markets can exist. Legal rights modifications prevent a competitive allocation of resources, creating potential rents for those willing to participate in illegal markets that are designed to avoid the laws. Under some circumstances, these illegal markets will have to involve corrupt law enforcement officials in order to exist, particularly when the market requires rights over which public officials have allocative discretion. Thus, those officials can extract part of the rents.

The Incentives for Corruption

Decisions are made on the basis of the information and incentives arising from the institutions within which the decisionmaker operates, and public officials react to their institutions' incentives just as private individuals do. Thus, relatively strong incentives to become corrupt are likely to result in relatively more corruption. The relevant incentives are those that Becker (1968) delineated in his economic theory of crime: the size of expected payoffs relative to a public official's alternatives, the likelihood of being detected and punished, and the severity of the potential punishment.

The Payoffs to Corruption

The attractiveness of the expected payoff to the individual public official from corruption depends on a number of factors. First, it must be emphasized that the potential returns to corruption will be weighed against returns to other activities that may have to be foregone if the official participates in an illegal market. Because they are not residual claimants, law enforcement officials cannot capture profits when they abstain from corruption and concentrate on enhancing efficiency in the production of law enforcement services. Of course, they may be able to move to a better paying public sector job because they perform

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especially strong position with regard to the control of illegal markets in correctional institutions. Although there have been virtually no comprehensive studies of corruption by corrections officers, there have been numerous reports of their active participation in the sale of drugs. In like fashion, various judges have been charged with participating in a burglary ring, setting up a protection racket, pimping, extortion, and other "entrepreneurial" offenses beyond accepting bribes and obstructing justice (Ashman 1973). And while corrupt police typically argue

> that money was thrown at them as they went about their day. . . . the public demanded corrupt cops, and it offered "clean" money . . . gratuities, favors, tips, gestures of good faith. . . .
>
> Instead [however] the massive government investigations of organized police scandals . . . have been based on illegal, aggressive, police activities in areas of bribery, extortion, conspiracy, and perjury. Cops become bullies, demanding "dirty" money . . . [Brashier 1977, p. x].

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their tasks well, but few public officials receive extremely large salaries. Officials may also gain satisfaction from the prestige they have and the power they wield, but their monetary rewards are likely to be small relative to comparable private sector employment. For instance, "some experts note that judicial virtue has been tested more than usual of late by failure of salaries to keep pace with the earnings of private attorneys" (Lacayo 1986, p. 66). Furthermore, many public officials are severely constrained as to how and how much they can *legally* earn above their public salaries. Thus, assuming that public sector employment was chosen because it was an official's best alternative (he or she is not likely to find a more attractive job in the private sector), any reasonably large expected payoff from corruption may be tempting.

The magnitude of the potential payoff from corruption is determined by several factors. The expected rents associated with the rights that the official is able to allocate are a primary determinant. Thus, *the greater the market distortion created by the laws being enforced,* the greater the potential payoff to officials doing the enforcing. Strict building codes or rigorous and geographically expansive zoning laws, for instance, generate the potential for large payoffs to corrupt officials (Gardiner and Lyman, 1978). In addition, when a market is entirely outlawed, the potential payments to public officials for protection of a black market monopoly position are enormous. The 1972 Knapps Commission Report (1972, p. 75) found evidence of payoffs to plainclothes police officers from gambling interests in New York to range from $400 to $1,500 *per month for each officer.* But gambling corruption is small time when compared to narcotics-related payoffs, which run into the hundreds of thousands of dollars. As one example, ten Chicago police officers were convicted in 1982 of taking $250,000 in protection money from narcotics dealers (Anderson 1982, p. 17). A federal prosecutor was recently charged with receiving payments of $210,000 along with a boat in exchange for tipping off a drug smuggler to the evidence-gathering activities (e.g., wire taps, hidden cameras) of U.S. Drug Enforcement Administration officers and to an upcoming indictment (Press and Starr 1986, p. 68).[3]

[3]When public officials go into the black market business themselves (see note 2) the potential payoff can be very large. Eleven Miami police officers were arrested for drug-related offenses in 1985 on charges ranging from cocaine trafficking and racketeering to robbery, aggravated battery, and murder (Anderson and Prout 1985, p. 32). One might wonder why public officials who turn to corruption do not always take over black markets rather than accepting bribes for allowing private markets to function without harassment. There are obviously considerations other than just the potential return that influence both the decision to take an illegal action and the type of action undertaken.

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Similarly, if an official has allocative power over a number of different rights, the payoff could be large even though no single right has tremendous value. The Knapp Commission (1972, pp. 2–3) found that "while individual payments to uniformed men were small, mostly under $20, they were often so numerous as to add substantially to a patrolman's income."

When the power to allocate rights is concentrated in the hands of one or a few officials, the corruption payoff to those individuals can be extremely large. Judges, for example, have near monopoly control over the dispensation of cases that come before them. Thus, one of the four judges found guilty as of January 20, 1986 (four others were still under indictment), as a consequence of "Operation Greylord" (a federal undercover operation to detect corruption in the Cook County court system) was convicted of, among other things, accepting bribes totaling $400,000 in cash as well as eight automobiles (Lacayo 1986, p. 66). A New Jersey judge was convicted in 1982 of taking $22,000 to release one convict from prison and put another on probation (Gest 1983, p. 42). Investigating officers have similar monopoly powers. If an investigator puts together a case against a particular criminal, he is in position to extort money or accept a bribe. The Knapp Commission (1972, p. 2) found that investigating detectives' "shakedowns of individual targets of opportunity" frequently "come to several thousand dollars."

On the other hand, if the power to influence a rights assignment is widely dispersed and, therefore, difficult to coordinate, the payoff to any one official is likely to be relatively small. Organized crime may have to bribe several police officers to ensure the relatively unmolested operation of their underground markets in drugs and prostitution, but this means that the payoff to any one police officer will be relatively small and less acceptable. (The payoff still may be quite attractive, given police salaries and other options, and the "problem" of small payoffs can be partially overcome by organizing the corrupt officials so monopoly power can be exploited.) Similarly, if a buyer of illegally allocated rights has several alternative sources (competitive corruption, if you will), then the return to any one corrupt seller is likely to be small. A pimp may be indifferent as to whether his prostitutes work in one or another of several geographically contiguous political jurisdictions with separate police precincts.

Monopolized corruption can arise because power is highly concentrated or because potentially competitive sources of corruption are able to collude. Organized corruption is not common. For instance, "plain clothes-men, participating in what is known as a 'pad,' collected regular bi-weekly or monthly payments amounting to as much

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as $3500 from each of the gambling establishments under their jurisdiction, and divided the take in equal shares" in New York City in the early 1970s. One set of indictments following the Knapp Commission report involved 37 plainclothesmen whose "pad" amounted to $1,200 a man each (1972, p. 11).

An obvious determinant of the payoff to corruption is the private buyer's willingness to pay for an illegal governmental rights allocation. Naturally, buyers in the underground market for governmentally controlled property rights react to the same kind of incentives that participants in any illegal activity do. Is the potential return relatively large or small? Is the action likely to be detected? How severe might the punishment be if the activity is detected? Given the evidence of police and judicial corruption, a substantial number of private sector individuals obviously find the potential returns from illegal dealings with officials to be sufficiently high relative to the risk.[4]

The Probability of Detection

If there is a high probability that an act of corruption will be detected and that a corrupt official will be identified and prosecuted, then an official is less likely to become corrupt. There are several possible ways to monitor law enforcement activities. Individual citizens in general and taxpayers and voters in particular might make efforts to monitor individual officials. This is far from the major threat to corrupt officials because of rational ignorance and the free-rider problem (Benson and Baden 1985). An individual citizen's share of the benefits derived by eliminating one corrupt official is so small relative to the costs the citizen may bear that he has virtually no economic incentive to act independently as a monitor. Monitoring costs are quite high, because of bureaucratic secrecy (Benson 1989) and the sheer size and complexity of the law enforcement process. Simply learning enough about bureaucracy to be able to identify a corrupt official can take a tremendous investment in time and effort. Thus, for instance, "state's or district attorneys . . . can be tempted to breach the law for money or political favors. They have wide discretion in pressing—or dropping—investigations, and most of the decisions they make are not put on the public record. How common abuses of this power are, no one knows, because prosecutors' decisions are seldom probed" ("Corruption," 1982, p. 46).

Furthermore, the citizen has little incentive to join in a collective effort to monitor law enforcers and incur part of the cost because he can share whatever benefits such a collective action may generate without bearing any of the costs. There are several fairly active

[4]For examples, see (Sherman 1974, 1978).

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government watch organizations that may pose some threat to potentially corrupt officials, but it is likely that these collective efforts will be relatively unsuccessful because of the free-rider problem. They simply will not be able to attract sufficient resources (contributions of time and money) to have a substantial effect. These organizations often claim to represent large constituencies, but they actually receive active support from only a small part of those constituencies. Thus, the general citizenry does not constitute a major threat to a corrupt criminal justice official.

The news media are one potential source of monitoring that does not necessarily fit into the preceding discussion. News does have some public good (or, more accurately, externality) characteristics, so there is a potential free-rider problem. But because consumers of news pay for much of what they consume indirectly through advertising, the undersupply of news services is not likely to be a significant problem. Nonetheless, there are reasons to expect that the news media will not be a major threat to most corrupt officials. Few members of the media devote much time to trying to *detect* the corruption of criminal justice officials. Corruption exposed by others is certainly reported, but there are relatively few instances in which news personnel have actively sought out illegal activity. This is partly because newspapers and other media require daily (or weekly) output, and most reporters must concentrate on news that can be obtained easily and quickly. Detecting corrupt officials and proving their guilt are generally difficult and time-consuming. Consequently, such efforts are likely to take place only when the potential payoff is substantial. A reporter might be willing to spend considerable time trying to demonstrate that an important public official is corrupt because the potential payoffs are large (e.g., front-page headlines, recognition by peers and citizens, and greater income opportunities), but he is unlikely to invest much time and effort to detect corruption by a low-level bureaucrat such as a police patrol officer. The resulting news story is simply not sufficiently valuable.[5]

Peers constitute a second source of potential monitoring. Most governmental institutions have established self-monitoring systems

[5]This discussion might imply that either (1) the news media are misallocating resources or (2) the citizenry must not care about political corruption. Neither of these implications should be drawn (Benson and Baden 1985). Some kinds of news (e.g., detection and exposure of political corruption) are very costly to produce relative to other kinds of news. Thus, it is possible that consumers of news have equally strong (or even much stronger) demands for reporters to expose political corruption but that these demands are not met because consumers are not strong enough to generate sufficient revenues to cover the cost of producing such news. In other words, a competitive industry produces what consumers demand as long as that demand is strong enough to cover costs.

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and have actually discouraged (and in some cases even prevented) monitoring from external sources. Police departments have internal affairs divisions, and court systems have judicial review boards. Such monitoring is not likely to be very effective, however, and poses little threat to a corrupt official. No matter what the goal of a governmental official might be, any official has strong incentives *not* to expose corruption (or inefficiencies) within his governmental unit. Suppose that a police official derives his satisfaction by working for what he believes is the "public interest" and is convinced that what his bureau is doing is vital. If he reveals that his colleagues are corrupt, the unit's effectiveness may be jeopardized; the corruption may reflect badly on the organization and lead to reductions in the unit's budget and discretionary powers. This is not to say that such a public-spirited individual would condone corruption; he may try to suppress corruption internally. But it seems likely that such an official would prefer not to know about corruption and, therefore, would make only modest monitoring efforts.

The Knapp Commission findings attributed police officers' reluctance to bring evidence against or to effectively investigate fellow officers to "intense group loyalty." This in turn supposedly manifested itself in something like a "public-spirited" concern for the effectiveness and morale of the department, which produced

> suspicion and hostility directed at any outside interference with the Department, and an intense desire to be proud of the Department. This mixture of hostility and pride has created what the Commission has found to be the most serious roadblock to a rational attack upon police corruption: a stubborn refusal at all levels of the department to acknowledge that a serious problem exists.
>
> The interaction of stubbornness, hostility and pride has given rise to the so-called "rotten-apple" theory. According to this theory, which bordered on official Department doctrine, any policeman found to be corrupt must promptly be denounced as a rotten apple in an otherwise clean barrel. It must never be admitted that his individual corruption may be symptomatic of underlying disease.
>
> This doctrine was bottomed on two basic premises. First, the morale of the Department requires that there be no official recognition of corruption even though practically all members of the Department know it is in truth extensive; second, the Department's public image and effectiveness require official denial of the truth.
>
> The rotten-apple doctrine has in many ways been a basic obstacle to meaningful reform. To begin with, it reinforced and gave respectability to the code of silence. The official view was that the Department's image and morale forbade public disclosure of the extent of corruption and justified any who preferred to remain silent. The doctrine also made difficult, if not impossible, any meaningful attempt

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> at managerial reform. A high command unwilling to acknowledge that the problem of corruption is extensive cannot very well argue that drastic changes are necessary to deal with the problem [Knapp 1972, p. 6–7].

The commission wholly rejected the "rotten apple" argument, finding that a "sizable majority" of the department was involved in various corrupt practices (1972, p. 61). It is interesting to note that despite the widespread publicity of the 1972 Knapp Commission report the recent police corruption scandal in Miami has produced the following argument: "Investigators say they believe that only a small percentage of Dade County's police officers are involved in criminal activity. But authorities agree that even a few bad apples are more than enough" (Anderson and Prout 1985, p. 32).

Police are not the only bureaucrats with strong tendencies to shelter their own. Most states have judicial review boards or systems of some kind that typically involve judges monitoring other judges. "Some critics complain, however, that judges cannot be counted upon to act against their own colleagues. . . . [T]he idea of firmly rooting out judicial corruption remains an especially sensitive one . . . [with] worries about 'the manifest danger' of losing public respect" (Lacayo 1986, p. 66). The similarity between justification for not revealing police corruption and justifications for not revealing judicial corruption is obvious. The analogy actually goes even further. A story dealing with "a growing list of judges who have run afoul of a [supposed] national crackdown on corruption and abuse of power," for instance, led off with the claim that "the 'few bad apples' on the bench are feeling the heat" (Gest 1983, p. 42).

It must be emphasized that the kind of incentives and behavior discovered by the Knapp Commission (and many others) can easily be attributed to self-interested motives rather than to the more "public-spirited" objectives emphasized by the commission. A similar implication applies to the public official for whom power and prestige are major sources of satisfaction. Corruption in that official's organization may lead to reductions in budget, discretionary power, and prestige. Finally, an official who is corrupt or who wishes to keep the corruption option open obviously will not want to attract attention to the corruption potential of his position. This explanation is particularly compelling in the Knapp Commission case (and in many others noted in this paper), because corruption was so widespread that it involved a substantial majority of the department. In fact, the commission (Knapp 1972, p. 61) concluded that "police corruption was found to be an extensive, department-wide phenomenon, indulged in to some degree by a sizable majority of those on the force."

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It is not very surprising, therefore, to find that in the relatively few instances in which an official has reported the corrupt activities of his colleagues, the official has often been ostracized by both colleagues and superiors, denied promotions, and ultimately forced to resign. When honest officials face such potential costs, it becomes even clearer why corrupt officials probably have little to fear from their peers.[6] Thus, "with extremely rare exceptions, even those who themselves engage in no corrupt activities are involved in corruption in the sense that they take no steps to prevent what they know or suspect to be going on about them" (Knapp 1972, p. 3).

A third source of potential detection comes from other governmental units. One function of elected representatives is to monitor bureaucracies to see that they are doing what their constituencies want them to do. Such monitoring could conceivably be very effective (assuming that the representatives are not corrupt) if there are relatively few officials to monitor and if there are relatively few rights over which those officials have discretionary allocative powers. Of course, the incentives faced by elected representatives depend on the opportunity cost of monitoring. As more time and resources are spent in monitoring, less is available for such things as determining the nature and strength of constituencies' demands (Benson 1981b), meeting those demands through legislative enactment (since reaching agreement in a legislature consumes time and resources; Ehrlich and Posner 1974), and taking advantage of outside income sources and benefits associated with legislative service (e.g., political junkets; Crain 1979). Even if there were only relatively few officials and rights modifications to be monitored, it would not necessarily follow that legislative oversight would effectively reduce corruption. Clearly, if large numbers of governmental officials have substantial discretion in the allocation of rights arising from the taxing, regulatory, and law enforcement processes, legislative monitoring is likely to be an ineffective deterrent to corruption.

A legislature may choose to delegate the monitoring function to some other governmental unit. Results of the Federal Bureau of Investigation's corruption detection efforts, for example, have been quite visible. "Operation Greylord" produced initial expectations of indictments of 30 court officials, including ten circuit judges on charges of fixing cases, bribery, extortion, mail fraud, and racketeering in the

[6]The threat to honest officials can be even greater; they may become the target for revenge. The first police officer that Frank Serpico approached in 1966 regarding police corruption (a captain and head of the Department of Investigations) warned him that he might well end up "in the East River" and suggested that he should forget about the problems (Knapp 1972, p. 197).

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Cook County Court system (Starr and Reese 1983, p. 21). As of January 20, 1986, eight judges had been indicted and four found guilty. But this was the culmination of a three and one-half year undercover investigation. How effective such investigative efforts are depends on how many resources are devoted to them. Law enforcement officers are expected to enforce a wide range of laws with limited budgets, so resources devoted to corruption detection generally should not pose a great threat to the overwhelming majority of corrupt officials. Expensive police efforts appear to involve a few, possibly spectacular arrests, perhaps in the hopes that the visibility of these actions will lead potentially corrupt officials to overestimate the risk of detection (but also because they often follow a highly publicized scandal, which results in a temporary political commitment to provide investigative resources). This may have the desired effect over the short term, but it may not work for long.

In many cases, the incentives of officials to monitor their counterparts in separate government bureaus, while perhaps relatively strong compared to the incentives for internal monitoring, are often quite weak. Prosecutors' offices, for instance, might appear to be in a good position to investigate police corruption, but they typically must rely on police officers to actually conduct an investigation. Perhaps more importantly, "in the case of the District Attorneys, there is the additional problem that they work so closely with policemen that the public tends to look upon them—and indeed they seem to look upon themselves—as allies of the police" (Knapp 1972, p. 14). The Knapp Commission found a general mistrust of the District Attorney's office by citizens because of the close ties between police and prosecutors. In fact, "this distrust is not confined to members of the public. Many policeman came to us [the Commission] with valuable information which they consented to give us only upon our assurance that we would not disclose their identities to the Department or to any District Attorney" (1972, p. 14). One implication of this distrust is that many prosecutors were also corrupt.[7]

When a government official has the authority to enforce a law that may generate a private sector underground market, that official has a valuable right to sell: the right to operate in the underground market without fear of arrest or punishment. The same argument applies when one official has the responsibility of preventing corruption by

[7]The Knapp Commission did not provide evidence of such corruption because its "mandate was limited solely to police," but it pointed out that their findings of widespread police corruption "doesn't mean that the police have a monopoly on corruption. On the contrary, in every area where police corruption exists it is paralleled by corruption in other areas of government" (1972, p. 5).

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other officials. The official with the power to enforce laws against corruption also has a potentially valuable right to sell: the right to be corrupt. Furthermore, he faces the same kinds of incentives as officials who are supposed to prevent underground activities in the private sector. Thus, it should not be surprising that public officials pay off police officers in order to practice corruption (Sherman 1978, p. 6). Of course, this means that potentially corrupt officials may be relatively less concerned about detection than they would be otherwise, because there is at least the possibility of bribery to prevent exposure even when they are detected.

Another reason for a corrupt official to be relatively unconcerned with potential detection by other bureaus is that such investigations are costly. "Operation Greylord," which required over three years of undercover work, was described as a "massive, Abscam-type probe in which FBI agents posed as criminals, on-the-take attorneys and bagmen brokering bribes for crooked judges" (Starr and Reese 1983, p. 21). One group of FBI agents who were attorneys, for example, set up a 30-suite law office in the La Salle Street legal district. The cost had to run into the millions of dollars. New York State had a staff of 45 monitoring judges in 1983, at a cost of $1.5 million a year (Gest 1983, p. 42). But most states, counties, and cities cannot commit such resources to monitor public officials, so they rely on existing law enforcement bureaucrats to monitor themselves and each other—at least until a major scandal erupts. Competing demands for common pool resources, however, provide those bureaucrats with a ready excuse for not actively searching out corruption. For instance,

> Although district attorneys are empowered to conduct long-range investigations and initiate cases, Bronx District Attorney Burton Roberts testified in executive session that the current normal case load is so heavy that only limited time and manpower is actually available to conduct long-range investigations. This limitation of manpower forces the district attorneys to restrict their activities with respect to police corruption largely to the prosecution of cases that have originated elsewhere. Their approach remains necessarily case oriented, as they have not had the resources to identify patterns of corruption and take action for long-range control [Knapp 1972, p. 257].

When bureaucrats face excess demand and have substantial discretion over how to allocate their resources, they can frequently justify ignoring corruption, particularly if it is not brought to the public's attention. Whether the public is better served by using those scarce resources in pursuit of corruption or in providing other services does not appear to be a question that is raised.[8]

[8]But the fact that "district attorneys, working as closely as they do with police officers,

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There have been numerous instances when a major corruption scandal has been exposed, and a special commission or task force is appointed to investigate the problem. The Knapp Commission followed the *New York Times* publicization of police corruption, which police officers Frank Serpico and David Durk had revealed two years earlier to high-ranking officials in the police department. In fact, "no general evaluation of the problems of corruption in the Department was undertaken until *The New York Times* publicized" Serpico's charges (Knapp 1972, p. 203), and only then did Mayor John Lindsay form the independent Knapp Commission. A related source of potential corruption detection involves political candidates who run on a "good government" ticket. Such campaigns, however, also typically follow a scandal.

The key point to the "scandal reaction" approach is that any alternative regime that does not address the fundamental institutional issues is unlikely to be successful over the long run. First, those who are corrupt can appeal to a concentrated constituency for campaign funds. Second, and more importantly, without changes in the fundamental institutions the replacements for those who are convicted, forced to resign, or defeated are likely to degenerate into corrupt behavior similar to their predecessors'.[9]

The Knapp Commission (1972, p. 61) noted that "the Commission's findings [of extensive police corruption] were hardly new. As long ago as 1844, when the State legislature created the New York police department in the country, historians record an immediate problem with extortion and other corrupt activities engaged in by police." The city has since been hit by periodic major corruption scandals, followed by special investigations, revelations of large-scale corruption, official expressions of outrage, and finally "reforms." But in each case, "the basic pattern of corrupt behavior was never substantially affected and after the heat was off, it was largely back to business as usual" (Knapp 1972, p. 61). A major investigation of police corruption seems to take place about every 20 years in the city.[10]

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also tend to be sympathetic to the police" (Knapp 1972, p. 256), for example, might affect the answer even if the question were asked.

[9]As Smith (1960, pp. 5–6) reported:

> There has been a whole series of police reforms. . . . There are campaigns to "turn the rascal out," and other campaigns to put them in prison. What has been the net result of all these excursions and alarms? Most of them have proved futile and quite without effect upon the ills which they were intended to cure. As often as not, law enforcement reformers have succeeded only in replacing one set of corrupt or incompetent officials with another set of the same or similar stripe.

[10]The Knapp Commission (Knapp 1972, pp. 61–64) revealed the following chronology

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Given that New York's last major police scandal was in the early 1970s, the city should be due for another one in the next few years.[11] Indeed, a political corruption scandal appears to be breaking in the city at this time. New York is certainly not unique in this regard. A major investigation of police corruption took place in Chicago between 1970 and 1976 (Beigel and Beigel 1977), but the corruption clearly did not end. In July 1982, over 20 Chicago officers were at some stage of investigation (arraignment, indictment, or conviction) for drug-related charges (Anderson 1982, p. 17). Corruption does not end when the "rascals" have been thrown out; they are probably no more "rotten" than any other typical resident of the same city or state. It is the institutional setting that creates the opportunity and the incentives for corruption.[12] Discretion occurs because of the excess demands made on scarce, commonly held resources. People generally react to incentives and take advantage of opportunities. As Ashman (1973, p. 173) noted regarding judicial corruption, "the argument that there are just as many crooked television repairmen or auto mechanics and the like doesn't hold up. No repairman or mechanic or anyone but a judge has unlimited control over the freedom and property of each member of his community."

The Severity of Punishment

One other potential source of disincentives for corruption is the severity of the punishment imposed when the corruption is detected. Corrupt law enforcement officials are occasionally caught, even in

of corruption in New York City: in March 1894, the Lexow Committee found systematic police extortion and payoffs throughout New York City; in 1912, a gambler who reported police corruption to newspapers was murdered, leading to appointment of a special investigative committee by the Board of Aldermen, which found systematic monthly extortion from gambling and prostitution; in January 1932, a legislatively appointed committee found that "the Police Department was deeply involved in extorting large sums from speakeasies, bootleggers and gamblers"; in September 1950, the head of a New York City gambling syndicate, Harry Gross, was arrested, agreed to cooperate with the district attorney, and detailed a payoff system; and in December 1972, the Knapp Commission report was issued.

[11]Given that the greatest threat to a corrupt official probably arises when some action is so blatant that a public scandal is created, the reason for choosing certain types of illegal activities over others becomes obvious. Accepting bribes to ignore black markets is much less likely to be detected and to create a scandal than active direct participation by a public official in the black market. Thus, the greater potential return is apparently offset by the greater risk in many cases. The probability of detection is a function of the type of corrupt act committed, as well as of the incentives facing potential monitoring groups.

[12]See William Brashler (1977, pp. ix–xii). The incentives and opportunities for corruption, by whatever name ("power," "discretion," "pressures," "temptations," "responsibility"), arise because of the politicized institutions of law enforcement.

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the absence of strong incentives to monitor for such behavior, but the effects of punishment are difficult to assess because severity is a subjective concept. An official who obtains satisfaction from a prestigious position may view the embarrassment of public exposure and the loss of a job as severe punishment; another with attractive outside alternatives might view such a response to be a minor inconvenience. The same can be said of punishment as a deterrent to private sector illegal activity, however, so at least some inferences can be drawn from a comparison of the types of punishment that corrupt officials face relative to punishment given criminals in the private sector.

If the incentives of officials who detect corruption in their own organizations are to suppress information and downplay the significance of the corruption in order to avoid embarrassment and the potential loss of discretionary power or prestige, then any internally generated punishment is likely to be relatively mild. Mild punishment should make the corruption appear to be relatively less significant to those outside the organization (e.g., legislators, assuming they are not corrupt, and private sector government-watch groups), thus minimizing the attention that exposure might attract. Judicial-discipline boards hear more than 3,500 complaints of misconduct each year, an average of one for every eight judges in the United States (Gest 1983, p. 42). These complaints include charges of corruption, but the majority involve favoritism (certainly something that could reflect corruption), abusive language, and other forms of overt misbehavior. It must also be recognized that many complaints were unfounded, coming from persons disgruntled over losing a case, but many were valid. Through the 1970s, review boards dismissed virtually every complaint, averaging some action against only about a dozen judges per year (Gest 1983, p. 42). This rate apparently increased during the early 1980s. In 1981, 152 judges were affected by review board investigations (Gest 1983, p. 42). Of those 152, however, only 16 were forceably removed from office, and 11 were suspended. Another 55 were officially reprimanded, and 70 simply resigned while under investigation and received no official punishment.

Retirement or resignation is frequently the route taken when a corrupt official is exposed (Ashman 1973, p. 202). A May 14, 1970, letter from the Law Department of the City of New York to the mayor (recommending the formation of an independent investigative committee, which became the Knapp Commission) pointed out that

> under present law a City employee is required to give 30 days notice before his retirement becomes effective. The Police Department has found that in many instances this time period does not permit a proper investigation and disposition of charges of corruption against

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> members of the police force, particularly if criminal charges are under investigation. Other city departments have encountered similar problems with regard to allegedly dishonest employees seeking to retire and obtain their pension benefits [Knapp 1972, p. 266].

The ability to retire and avoid punishment that might be meted out by an internal investigation is both a reason why reliance of self-policing is unlikely to be effective and an excuse for not publicizing suspected corruption. Announcing that "the 'bad apple' resigned so there is nothing we can do to him internally and therefore there is no need to pursue the case further" is a convenient escape for bureaucrats wishing to avoid a departmental scandal.

When punishment arises as a consequence of detection by another organization or a private government-watch group, it could be relatively severe as compared to that generated within a corrupt official's governmental organization. In fact, however, public officials (particularly high-ranking officials) seem to receive relatively short prison terms and to be parolled relatively quickly.[13] As the Knapp Commission reported (Knapp 1972, p. 253): "A dishonest policeman knows that, even if he is caught and convicted, he will probably receive a court reprimand or, at most, a fairly short jail sentence. Considering the vast sums to be made in some plainclothes squads or in narcotics enforcement, the gains from corruption seem far to outweigh the risks."

Increasing Criminalization, Growth of Law Enforcement, and Corruption

If historical trends toward more criminalization and discretion continues, as well as the growth of public enforcement bureaus (see Benson 1988, 1989), one can predict that corruption among law enforcement officials will rise. Such a prediction may appear to be trivial: The growth of law enforcement bureaucracies means more governmental employees, so that if some percentage of public officials are corrupt, corruption should increase. But this prediction goes beyond such an obvious relationship. Based on the preceding explorations of the institutionalized opportunities for and the incentives

[13]During the four and one-half years after the Serpico incident, the five district attorneys' offices in New York City initiated 136 police corruption cases involving 218 officers (Knapp 1972, p. 252). Of the 80 who had been sentenced at the time of the Knapp Commission report, 49 were freed or given suspended sentences and 14 of the 31 who received jail sentences faced terms of less than one year. Interestingly, from 1970 to 1973 there was also a 90 percent turnover in the rank of captain and above, apparently due to retirement, but virtually every criminal charge was brought against ranks of lieutenant or below (Sherman 1978, p. 7). The obvious implication is that punishment for police corruption is likely to be relatively light and is likely to decline as the official's rank increases. Ashman (1973, p. 7) found the same to hold for judges.

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to commit corruption, we can anticipate that the number of law enforcement officials involved in corruption will rise at an increasing rate.

The relationship between increasing criminalization and the opportunities for corruption is obvious. Greater criminalization means that more property rights are controlled by governmental officials, so there are greater possibilities for the illegal sale of such rights. Incentives for participation in private sector underground markets increase, so enforcement officials have additional opportunities to accept bribes in return for altering rights structures or for allowing individuals or groups to operate illegally without fear of punishment. Clearly, if the incentives to commit corrupt acts do not change with growth in public sector law enforcement, we would still predict increasing corruption simply because of the expanded opportunities for corruption. But such growth also leads to stronger incentives to become corrupt.

Consider the effects of an expanding criminal justice system's implications for the potential payoff to corruption. This really means that private sector or market activities are increasingly constrained as property rights allocations gravitate toward public officials. The more severe the legal constraints on private markets and private behavior, the more valuable become the rights controlled by public officials. Correspondingly, the payment likely to be offered a corrupt official increases. Furthermore, as public officials acquire the power to make ever-greater numbers of rights allocations, the potential returns to corruption expand even if no single right has tremendous value. Because increasing criminalization leads to greater potential payoffs to corruption, the incentives to be corrupt become stronger as criminalization increases.

The growth in the size of the police, prosecution, and judicial sectors has two implications here. First, an expansion in the number of public officials with some discretionary powers to allocate rights means that monitoring for corruption should become increasingly ineffective. Monitoring efforts must be spread over more and larger agencies. Thus, detection of a corrupt public official becomes less likely, and each official's incentive to avoid corruption is reduced. Of course, if resources devoted to monitoring are expanded *proportionately* to public sector expansion, corruption incentives need not increase. But it is doubtful that this will occur. Relatively fixed legislative resources to monitor corruption must be spread over more and more potentially corrupt governmental employees. In fact, legislators' monitoring efforts are likely to decline in total as well as on a per official basis as its decisionmaking workload increases. The legislature might choose to delegate monitoring responsibilities to

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another governmental organization, but I can think of no legislation that delegated power to enforce a new law and at the same time provided resources to monitor for possible corruption. There appears to have been some recent general increase in resources committed to control corruption (Gest 1983, p. 42), but this commitment falls far short of being proportional to the growth in government in general and in law enforcement bureaucracies in particular. At least in a relative sense, monitoring has been reduced. The incentives for private citizens to become involved with government-watch organizations should also increase, so private sector monitoring efforts may expand as government does. The free-rider problem, however, is still likely to stand in the way of any effective monitoring. Thus, detection becomes less likely as government grows and as incentives to become corrupt increase.

Directly related to the relative reduction in monitoring is the second implication of the growth of public enforcement agencies and the fact that detection of corruption becomes less likely. The risk of detection to individuals paying bribes declines concurrent with a reduction of risk to those receiving bribes. Thus, individuals become more willing to enter into underground transactions with public officials, while more opportunities for corruption become available. Furthermore, the reduced risk to bribe-payers is likely to make them willing to pay larger bribes for any right that a corrupt official offers for sale. The payoff to corruption increases, and corruption becomes even more attractive.

Many government officials would probably contend that these arguments are incorrect. They would point out the stepped-up effort and success of law enforcement authorities, particularly at the federal level, in detecting corruption during recent years. The U.S. Department of Justice's public-integrity section has been pursuing charges of corruption since 1976 ("Corruption Is Still a Fact of Life" 1982, p. 46), and the FBI's Abscam and "Operation Greylord" have been very visible success stories. Even state governments have become active in detecting corruption. Since California established the first judicial-conduct board in 1960, every other state has followed suit (Gest 1983, p. 42). A special section in the New York State attorney general's office has successfully prosecuted several hundred police and judicial officers. The official conclusion typically sounds like this: "Most experts believe there is less crookedness in law enforcement today than in the past" ("Corruption," p. 46), or "All in all, misbehavior on the bench stands a better chance today of being corrected than ever before" (Gest 1983, p. 42).

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There certainly have been a number of scandals in recent years, but is the surge of judicial and police corruption cases evidence of the success of increased policing, which should imply that less corruption will occur? Or is it evidence of increased corruption? Certainly, if corruption increases as government grows, there is greater likelihood that some official will make a blatant mistake that brings him into the public eye and necessitates an official inquiry.[14] The point is that as corruption increases the likelihood of scandal and politically motivated responses also increases. Thus, governments at all levels will put some additional resources into detecting corruption. These responses will still generally involve case-by-case investigations initiated by scandals, however, with little in the way of long-run changes in institutions and incentives. Ashman (1973, p. 174) explained that "the states have given increased attention to the judicial discipline problem and tried to establish methods for coping with it. But, whatever machinery exists, it is seldom employed. Judges and lawyers are loath to take on other sitting judges." The commitment of additional resources in the public sector does not guarantee that they will be used effectively, for all the same reasons that public sector employees are reluctant to report corrupt acts by their colleagues.

Officials steadfastly cling to the assertion that corruption involves a few "rotten apples" and is not an institutional phenomenon. Louisiana judge Thomas Wicker, in commenting on the large number of charges brought against judges over the last few years, claimed that "most judges are honest and conscientious. The discipline process is taking care of the few bad apples" (Gest 1983, p. 42). This kind of attitude implies that once the scandals die down, the bad apples will be out of the system and the high level of corruption exposure will decline. But the upward trend will continue, regardless of what officials claim. It appears that "except in circumstances where the problem reaches outrageous proportions, nobody monitors the progress of criminal cases to detect abuses of prosecutional discretion; nobody raises money to support political campaigns of candidates who will eliminate police corruption; nobody watches the sentencing patterns of judges" (Neely 1982, p. 154).

Conclusion

How widespread is corruption among criminal law enforcement officials? If the arguments presented are valid, then it is impossible

[14]"Operation Greylord" grew out of widespread public suspicion of cases being fixed in the Chicago court system, which led the state's attorney's office to approach the FBI for help (Starr and Reese 1983, p. 21).

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to answer this question, because most corruption is never reported. But Smith (1960, p. 13) believed that one of the features that stood out in his examination of U.S. police systems was "the prevailing influence of corruption." Sherman (1978, p. 7) examined four police scandals that resulted in large-scale investigations—Oakland, California, in 1955; New York City in 1970 (the Serpico/Knapp Commission); Newburgh, New York, in 1972; and "Central City" in 1974. He found that prior to the scandals police corruption was highly organized in all four cities. Most corruption arrangements involved more than one officer, high-ranking officers (including the chief in Newburgh), a range of corruption activities (e.g., vice protection, police burglary, and extortion or theft from arrested citizens), and strong linkages between corrupt politicians and corrupt police.[15]

When the scandals were discovered, new police executives were appointed with mandates for reform. There were criminal convictions (23 percent of Newburgh's officers were removed), and pressure was applied to high-level or long-time officers to retire (in New York there was a 90 percent turnover in the rank of captain and above in three years). "Reforms" were put in place and "other 'reforms' of earlier times which, in the current context, were thought to be conducive to corruption" were dismantled (Sherman 1978, p. 8). The deterrent effect of the scandal appeared to be very short-lived, with corruption returning to its pre-scandal level in about two years in "Central City." The strategies employed there did not change significantly from those that had been employed before the scandal. The other three cities did appear to suppress "organized" corruption for awhile, although some apparently had re-emerged by (or persisted through) 1978. And unorganized corruption that is less vulnerable to detection persisted despite the investigations. Sherman (1978, p. 12) concluded that "the low-visibility opportunities for corruption events inherent in police work make police organizations perhaps more likely than other organizations to have a continuing problem of misconduct." Other cities have similar characteristics to the four that Sherman examined, so there seems to be little reason to doubt that corruption among police is widespread. In all probability, "bribery and extortion rings exist in police departments all over the country" (Breshler 1976, p. xii).[16]

From some perspectives, of course, corruption may not be all that bad. As Becker and Stigler (1974, p. 6) pointed out, the desirability

[15]In fact, "politicians in all the cities but New York were reportedly arranging for police protection of vice operations" (Sherman 1978, p. 6).

[16]The same general conclusions hold for judges. See Ashman (1973, p. 5).

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of the suppression of corruption "depends on whether laws are passed in the 'social' interest or to reward special interest groups. . . . For example, bribes that reduced the effectiveness of many housing codes, of the laws of Nazi Germany against the Jews, or of the laws restricting oil imports, would improve, not harm social welfare (although not as defined by the legislature)." But it is not clear that all corruption is this selective. Furthermore, perhaps we should be concerned with the moral foundation of a society that requires the corruption of public officials to achieve desirable ends.[17]

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[17]Three years after his appointment to the highest judicial position in England, Sir Francis Bacon was impeached, having accepted at least 28 bribes. He justified his actions by pointing out that "I usually accept bribes from both sides so the tainted money can never influence my decisions" (Ashman 1973, p. 3).

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Entrepreneurship and Rent Seeking in India

Roby Rajan

Introduction

The role of entrepreneurship has never been far below the surface in discussions of rent seeking. In both market and nonmarket institutions, competition is ever-present; and since Adam Smith, the harnessing of entrepreneurship toward privately and (simultaneously) socially useful ends has constituted the principal justification of market institutions. In contrast, when institutions are nonmarket, entrepreneurship is often directed toward privately rewarding but socially wasteful ends. This form of entrepreneurship is directed at redistribution—i.e., diversion of value away from others—in contradistinction to market entrepreneurship that creates rather than diverts value (Buchanan 1980). Nonmarket entrepreneurship arises most often due to governmental action in various forms. It is most explicitly demonstrated in the case of government-sponsored monopoly, where in addition to the traditional Harberger (1954) deadweight welfare loss, society also incurs the loss of resources expended by each of the contending entrepreneurs seeking to transfer surplus from consumer to producer. It is to be expected, therefore, that the more extensive and entrenched such institutions are, the less value is created in society and the slower the rate of economic growth.

The term "entrepreneurship" is used here in a somewhat unfamiliar sense. In its traditional Schumpeterian meaning, entrepreneurship is the value-creating force in a competitive market order where the potential for rents provides the incentive for resource owners to seek out more efficient allocations of their resources. The

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presence of positive rents promotes entry by competitors into some activities, even as negative rents cause some resource owners to exit from theirs; returns are thereby restored to their normal levels over time.[1]

The question of what constitutes the stuff of entrepreneurship cannot be directly answered from the postulates of received neoclassical theory, but Liebenstein (1968, p. 74) has listed some of the characteristics that entrepreneurs may possess. These include the ability to "search and discover economic opportunities, evaluate economic opportunities, marshal the financial resources necessary for the enterprise, make time-binding arrangements, take ultimate responsibility for management, be the ultimate uncertainty and/or risk bearer, provide and be responsible for the motivational system within the firm, search and discover new economic information, translate new information into new markets, techniques and goods, and provide leadership for the work group." A striking feature here is the dependence of these characteristics on the *economic* opportunities mentioned at the head of the list. These opportunities are not exogenously given but are the product of a discovery process. As Kirzner (1980, pp. 17–18) put it: ". . . a concatenation of possible events may not be noticed at all unless the discoverer stands to gain from the price differential. In order to switch on the alertness of a potential discoverer to socially significant opportunities, they must offer gain to the potential discoverer himself . . . the most impressive aspect of the market system is for such opportunities to be discovered."

Although these opportunities are not exogenously given but are revealed only through entrepreneural discovery, it is nevertheless crucial to note that what *must* be given exogenously to potential discoverers are the institutions that make possible such discovery. As Demsetz (1983, p. 278–79) put it: "It is not enough to recognize that oil, not water, is coming from the ground—although even this involves the prior acquisition of the knowledge needed to distinguish between the two. A mind must devote itself to considering the prospect and judging its potential. That is a mind diverted from other tasks; therefore there is a cost to maintaining alertness. Alertness itself is a form of investment under conditions of uncertainty." When societal institutions make the opportunity cost of economic alertness high and that of political/bureaucratic alertness low, entrepreneural individuals may rationally be expected to invest their time, energy,

[1]The role of the entrepreneur in neoclassical general equilibrium theory, however, is rather more obscure. As Baumol (1968, p. 66) observed: "[B]y ignoring the entrepreneur we are prevented from accounting fully for a very substantial proportion of our historic growth . . . yet the theoretical firm is entrepreneurless—the Prince of Denmark has been expunged from the discussion of Hamlet."

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and resources in pursuing political/bureaucratic opportunities rather than economic ones. Within such institutions, entrepreneurship will get translated into socially malevolent rent-seeking activity. Rent seeking then obtains in some settings and traditional profit seeking obtains in others, not because of differing modes of rationality among economic agents but because of the institutions that characterize those settings.

Some economists hold the view that entrepreneurship is a scarce resource like other economic resources and that poor countries are characterized by a particular scarcity of it (Lewis 1955, p. 196). The scarcity of entrepreneurship has subsequently been advanced as a rationale for governments to establish state-owned industrial enterprises (Government of India 1951). Others draw a sharp distinction between entrepreneurship and the traditional factors of production. Kirzner (1973, p. 66), for example, maintained that "the search for the elusive analytical category of entrepreneurship stems from the insight that an explanation of the market phenomenon of pure profits implies a role in the market which cannot be reduced to just a special kind of productive factor." The critical relationship between entrepreneurship and economic growth is not much in dispute, however, and most economists agree with Leibenstein (1968, p. 81) that "the motivations present—e.g. the profit rate—are such that those with gap-filling capacities are willing and able to exert themselves under some motivational circumstances and reduce the degree of exertion under others." These motivational circumstances thus determine the outcome of entrepreneural behavior, and it is in regard to these circumstances that public choice theorists such as Tullock (1984) have suggested that widespread rent-seeking institutions are the most significant cause of poverty in poor countries.[2]

By focusing on entrepreneurship as alertness to opportunities permitted or constricted within exogenously given institutions, this paper attempts to show that rent-seeking theory can shed light on many aspects of empirical reality that are commonly observed in poor countries. Although the example of India is used here, economists have made similar empirical observations in many other poor countries (Bauer 1981) and explanations similar to those offered here suggest explanations for the rest of the "developing world."

Rent seeking is analyzed in this paper as a two-stage process of rent capture and subsequent defense/augmentation. The paper is organized accordingly. First, rent-seeking theory is discussed briefly

[2]Referring to the U.S. economy, Tullock (1984, p. 235) also expresses the fear that "the trends point to more and more rent seeking. Unless something is done to stop these trends, we may end up in the same situation as the backward societies."

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using the property rights paradigm. Next, the nature of the specific investments made to capture public sector rents is elaborated upon and the various post-capture welfare losses are discussed. A rent-seeking explanation of the persistence of India's traditional caste system is then offered. The final section of the paper concludes with some normative implications of the analysis.

Rent Seeking and Property Rights

From the very genesis of the rent-seeking literature, India has been a classic example of the rent-seeking mode: there are government controls on investment, capacity creation, expansion, diversification, choice of technology, location, pricing, distribution, imports, foreign collaboration, private foreign investment, use of foreign exchange, credit supply, and so forth. In her seminal paper, Krueger (1974) estimated that the annual welfare costs from rent seeking due to India's import-export regulations were approximately 7 percent of GNP. Mohammed and Whalley (1984) subsequently estimated that if controls in capital markets, goods markets, and labor markets are included in the rent-seeking calculation in addition to external controls, then annual welfare costs are 35 to 40 percent of GNP. These studies suggest that in the context of the economy of a poor country, welfare losses induced by rent seeking are likely to be more significant than the losses originating from the traditional price-distorting effects of taxes and subsidies. This paper focuses particularly on state and local rent seeking rather than on the rent seeking that arises from federal controls. Although federal controls are the focus of much rent seeking due to the substantial rents lodged therein, entry barriers are also high. As a result, the ordinary citizen is most often an entrepreneur, not in the federal rent-seeking industry but in rent seeking at the state and local level. The anatomy of "underdevelopment" is thus best understood at this level, where ordinary citizens face the incentives and opportunities created by relative prices and wages and make choices correspondingly.

State and local public sector rents are lodged primarily in government and political jobs, and individual investment is directed primarily at acquiring them. Entrepreneurs who are unsuccessful at rent seeking are subsequently forced into the tax-generating economy, where relative rates of return to investment have been lowered due to administrative regulation[3] and the high tax rates imposed to

[3]In India, these range from "target capacity creation" in "key sectors" reserved for government to detailed product-level setting of output and price levels (Bureau of Public Enterprises 1986).

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support the entrepreneurs who capture the scarce government and political jobs.

Rents available to those who are successful in capturing these rent-access positions make politics and the civil service differentially productive employments. The rents are lodged in political offices, the administrative bureaucracy, and state-run "public sector corporations."[4] These rents are in the form of the present discounted value of the excess of government salaries and perquisites over incomes for similar services in the private sector, bribes that can be exacted for disbursing permits and licenses, opportunities for theft of the public assets for which government officials are responsible, and threats of job nonperformance.[5] The allocative unnecessity of these payments to attract people of comparable quality to these jobs makes these payments economic rents. Once the rents are captured, there is a lifetime guarantee of payments so that entrepreneurs who are successful in securing these jobs by investing in education, political lobbying, and so forth are in essence able to convert these positions into private property rights.[6]

Buchanan (1980, p. 5) observed that "rent seeking analysis can readily be incorporated within the property rights approach." Jagannathan (1986) further explored rent seeking as a process of property rights assignment. Unlike the textbook production function, production in the property rights paradigm is not a matter of physical output possibilities, given input quantities, knowledge, and the state of technology; it is rather a matter of the structure of property and contracting rights and the consequent incentives that confront indi-

[4]These corporations are not firms in the Coasian sense but governmentally created organizations that are statutorily granted monopoly over the domestic market. This was justified as follows in India's first five-year plan: "In the public sector the direction of investment is not governed by the profit and loss calculus; it has also to take into account wider considerations" (Government of India 1951, p. 26). These wider considerations were said to include "employment creation, export promotion, rapid growth in output and sales, import substitution, good employee relations, promoting technological self-reliance and independence, and promoting balanced regional development" (Bureau of Public Enterprises 1986, pp. 13–27).

[5]To appreciate the magnitudes of these rents, a useful example is provided by Wade (1985, p. 475) in his study of the irrigation department of an Indian state. Individuals who had *already* captured rent-access positions in this department were willing to bribe the relevant bureaucratic/political authority between Rs. 1,200,000 and Rs. 1,500,000 (or some 40 times the average annual official salary in that rank) for a two-year period as superintending engineer in the prized coastal areas of the state. In that year, India's annual per capita income was approximately Rs. 2,500.

[6]Being scarce goods, the concept of property rights readily applies to these positions. As Furubotn and Pejovich (1976, p. 3) observed, "the concept of property rights . . . applies to all scarce goods."

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vidual entrepreneurs. The "firm" in this view essentially serves as a nexus for implicit or explicit contracts among individuals, and "production" occurs whenever individuals contract with one another for services. Rent seeking can then be said to occur in institutions that embody property rights that encourage the production of outputs with no welfare valuation (e.g., political lobbying) as opposed to market institutions that induce value-adding production. When viewed as such, rent-seeking welfare losses consist of the total social cost of all resources expended to capture a property right through governmental assignment.

A singular feature of the property right in a government job that have been secured in this manner is the legal prohibition against marketability of the claim on the sequence of future cash flows that have been captured by the rent-seeking activity. Rent extraction, in other words, is conditional on employment, the sale of the right to become a government employee being prohibited. The welfare costs of public sector rent seeking, therefore, can be alternatively formulated in terms of this prohibition of tradeable claims on the cash flows deriving from the rents embodied in government jobs. Specified in this way, the rights structure determines the individual's incentives and, therefore, the social ends to which maximizing entrepreneurs will direct their investments. The absence of nonattenuated property rights in the scarce government and political jobs sets in motion investments in organizing interest groups, lobbying, education, vote-seeking, and bribery to have the scarce right assigned. After discounting the probability of failure and the high return if success is achieved, individuals will continue investing resources in such activity to the point where the marginal expected return matches that on other possible resource investments. Resources will then have been invested by each contending entrepreneur to the point where the present discounted cost of the resource investment is equal to the present discounted value of the job. Such investments, however, differ from traditional profit-seeking investments in one crucial respect: no social asset is created.

Rent Seeking as Investment without Asset Creation

In poor countries, where individual ownership of physical capital is at relatively low levels, the education market is an especially significant medium for various types of transfers; and the potential for such transfers gives rise to rent-seeking activity. Transfers may be carried out with a minimum of social resource waste, or they may be carried out with considerable social waste. In this section, we

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examine a variety of rent-seeking costs arising from the inefficiency of the transfer methods employed. To highlight these inefficiencies, consider a hypothetical scenario in which scarce government jobs are converted into marketable private property rights by direct auction. In this case, government could initially secure the full value of the rents that it currently forgoes when entrepreneurs have to make various forms of investment other than direct pecuniary payment to goverment. These direct payments could then be treated like normal tax revenue and spent for governmental purposes.[7] It will be argued that a system that includes the additional right of marketability would be allocatively more efficient than the government job/contract-seeking system currently practiced in India.

A major form of investment that job-seeking individuals in India currently make is in human capital acquired with a view to satisfying government stipulations for specific jobs. These stipulations, however, are qualitatively different from human capital acquired in response to market-generated incentives, and no definitive claim can be made *a priori* that positive social externality will result from such bureaucratically and politically determined requirements. The extent to which such a claim would be valid depends on whether or not the resources invested by the successful job-seekers improve their efficiency on the job and on the relative magnitude of the costs imposed on the economy by these job-seekers. The social cost of such investments is a large multiple of the investments made by the successful job seekers, because the number of people who spend time, energy, and money preparing for the necessary examinations is a very large multiple of the number of available jobs. In addition, the examination-specific human capital (e.g., for the civil services examinations) acquired by the rent-seeking entrepreneurs is rarely of any use in any other economic activity. With no real asset created due to the nontransferability of the investment to other uses, the overwhelming majority of the entrepreneurs get no return at all on their educational investment; they become the "educated unemployed." Such invest-

[7]Rent seeking would then shift to some other level within government (Buchanan 1980). The sale of government jobs is not without historical precedent; it was the rule in the states of 17th- and 18th-century Europe (Swart 1949). Purchasers of public offices in France, for example, had to put up large sums of money for the job; but once bought, they held it for life, receiving a return on their outlay in the form of fees, gratuities, and extortions. These jobs could also be sold by the incumbent in the open market or willed to whomever he pleased. On the efficacy of the resulting service, Tullock (1980, p. 22) observed that "during the period of two hundred years before the French Revolution (the period in which this system operated), France was usually accepted as the most powerful and progressive state on the continent of Europe. Certainly it would be hard to argue that its government was worse than its contemporaries."

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ments continue to be individually rational, however, which leads to a growth of the high school–college–"personal tuition" industry.[8] Economically, however, this waste of resources is identical to the social resource waste of traditional rent seeking, such as the cost of maintaining lobbyists who cultivate license-dispensing bureaucrats in the capital city. No economic value is added in either case.

We have assumed that the screening and selection process for these examinations (stipulated by regulation as a prerequisite to compete for the rent-access jobs) is neutral. In reality, however, graders of the relevant examinations exact rents for high grades so that professors compete to obtain the graderships, resulting in social resource waste. Rents are also secured by those on the "interview boards" for government jobs.[9] There is, then, the rent-seeking cost of officials expending resources to obtain interview board jobs. The only difference between the system in prerevolution France and the present system in India is that it is not the government that directly captures these rents but those individuals who have successfully captured rent-access positions, such as public offices in interview boards and graderships for examinations. In addition to the resource waste of the job seekers, therefore, there is waste due to the competition that sets in to gain access to these other forms of rent. If the pure auction system were adopted, resource waste in competition for the jobs would be avoided, resource waste in competition for interview board memberships and examination graderships would be avoided, and government could receive the full value of the rents. If, on the other hand, all jobs were openly for sale by interview board members, there would be rent seeking by prospective board members (who are politically appointed) but none by job seekers. This situation would also have welfare-enhancing effects because the rent seeking would be only for the assignment of property rights among prospective

[8]*India Today* reported in its November 30, 1987, issue that for the 2,000 seats open to high school graduates in 1986 at the public sector Indian Institutes of Technology (IIT), "several lakhs had applied" (1 lakh = 100,000). In the same issue, an upper-middle class high school graduate from Madras (who had 3 personal private tutoring sessions a day from different instructors to prepare for the requisite entrance examinations), when questioned about his ambitions, informed the reporter that "his goal was IIT and then Caltech." When asked what he wants most out of life, the reply: "A good job, a huge big house, a chaffeur-driven imported car." Public support for such private ambition is an underexamined issue in the literature on developing countries.

[9]For the various departments under the state government, this board is the state's Public Service Commission, which screens all job-seekers and awards an "entry rank" to every entrant; this rank determines all subsequent career promotions. Although the competition for rent-access positions in the federal government is similar in many respects to the state level rent seeking described in this paper, there are also important differences that manifest themselves in ways different from those described here.

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board members, with society saving on resource expenditure by all job seekers.

It is useful at this point to consider the tax incidence of the educational system that generates the job seekers. The chief source of state revenue is taxation in the form of various value-added taxes and sales taxes on items of mass consumption. Given the low standard of living for the majority of the population, this tax burden is sharply regressive and falls most heavily on those who are the worst off. The subsequent tax support for higher education is a regressive transfer as well; that is, the revenues spent on higher education usually end up benefiting individuals in the upper income brackets who can afford the requisite investments in time, private coaching for the entrance examinations, and so forth. Professors and other employees who capture the scarce rent-yielding jobs at public universities and colleges are also beneficiaries of this transfer.

The economic justification for public higher education is normally offered in terms of the positive externalities produced because college graduates are more productive than they would be without that education, and the additional productivity accrues to society as a whole. Tullock (1983, p. 142) expressed skepticism about such claims. In the context of poor countries, it is much more plausible that public higher education serves largely to turn out ever-larger numbers of the "educated unemployed," which, if anything, produces social unrest by frustrating the heightened personal expectations of large numbers of citizens. In a society where only a small fraction are fortunate enough to obtain employment in the government sector, the benefits of education are captured entirely by the person who receives the education in the form of rents lodged in the government jobs that he or she manages to secure. In India, there is also a statutory maximum age for entry into the officer cadres of government service (usually the late twenties). The initial rank is set by the Public Service Commission, an interview board of government bureaucrats, and higher ranks are filled only by promotion within the service. A person entering service below the rank of officer can never be reclassified as an officer. Successful rent seekers, therefore, are necessarily individuals who have enough resources to devote to educational investment early in life; people in the lower income brackets who may choose to go to vocational schools or to college later in life are systematically excluded.[10] Nevertheless, a small percentage of lower-income individuals of superior ability do find their opportunity sets

[10]In the irrigation department of a typical state, Wade (1985, p. 490) noted, "The difference between Supervisor and Junior Engineer is that the latter has a university

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enlarged due to publicly subsidized higher education and the eventual prospect of a government job. Such educational investment by entrepreneural individuals is precisely the kind that Leibenstein (1968, p. 82) described as "dysfunctional" in that "it increases the opportunity costs of potential entrepreneurs and may as a consequence decrease the supply of entrepreneurship." The investments discussed in this section, however, do not reflect the total welfare cost of these institutions. Significant social costs are also incurred subsequent to rent capture.

Post-Rent Capture Welfare Losses

In the property rights approach to social cost, the problem of "market failure" is seen as the absence of nonattenuated property rights, and the extent to which property rights will be established is a function of the transactions costs involved: the lower the transactions costs, the easier property rights can endogenously evolve. When nonattenuated rights are involved, this combination is usually welfare enhancing because mutually beneficial exchanges can subsequently take place. But the property rights that evolve in the political arena into bureaucratic sinecures are what Buchanan (1980) described as instances of "diversion of value" from taxpayers rather than "creation of added value," the value-diversion process that consumes the resources involved in rent seeking. The excess supply of these bureaucratic property rights is welfare-decreasing because of various post-capture welfare costs.

Post-capture welfare losses occur because successful rent capturers become, in effect, agents without principals for a wide range of actions. While supervisors impose some control on the job, both subordinate and supervisor operate with a fair amount of freedom permitted within the constraints of rent-sharing with the relevant bureaucratic/political superiors on the one hand and unusually excessive public harassment (which may affect the local legislator's prospects) on the other (Wade 1985). When successful rent seeking yields guaranteed payments until retirement, such entrepreneurs face strong incentives to convert the public assets for which they are responsible into personal wealth. The planning horizon used by successful entrepreneurs with regard to government assets is their expected employment retirement date. Public projects for which the true risk-adjusted

degree in engineering, the former has only a two-year post high-school diploma in engineering. The difference in time spent in tertiary education is small, but makes a profound difference to their career structures. Supervisors are promoted, if at all, only at the end of their careers; Junior Engineers can expect much earlier promotion."

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present value of cash flows exceeds the present value of outlays have no necessary correspondence with the projects that maximize the net present value of the entrepreneur's cash flows captured by his rent-seeking activity. With no mechanism corresponding to market discipline that can elicit the true expected payoffs and risks, information on expected payoffs and risks for public funding requests will be projected so as to correspond with the entrepreneur's planning horizon. By reducing, postponing, or eliminating maintenance on government assets and by using material of substandard quality, successful rent seekers can also pay themselves higher salaries and perquisites.[11]

This problem is exacerbated in cases where the major negative effects of such action occur beyond the entrepreneur's planning horizon. Therefore, it is common for dams to leak and bridges to collapse soon after the officials entrusted with their construction have retired. Government-sector borrowing as a whole similarly makes larger current salary payments and fringe benefits available by postponing the repayment burden beyond their own planning horizons.

Such behavior could conceivably be monitored in a market in which the value of rent-seeker claims get capitalized and traded. Successful rent seekers would then have the incentive to maximize the value of their claims by the optimal acquisition and maintenance of assets. Without such a market and the consequent lack of a control mechanism for the successful rent seeker's behavior, the incentives are to run down inventories, appropriate state resources as personal wealth, and generally employ government assets improperly leading to their deterioration. Several bureaucratic agencies have been set up purportedly to monitor such behavior throughout the government sector. Every state in India has an Anti-Corruption Bureau made up of police officers and officers from the various government departments. It investigates a case when asked to do so by the relevant minister or his secretary. An investigation results in a confidential report of findings, on the basis of which the government decides on a course of action. The government subsequently submits a confidential report to the state's Vigilance Commission, a body widely

[11]In the irrigation department studied by Wade (1985, p. 474), "the desirable posts tend to be in Construction and in Operation and Maintenance (O&M) units, the undesirable ones in Investigations and in Designs . . . an Assistant Engineer in an O&M post on an upland canal might expect to earn illicitly at least one to two times his annual official salary each year, net of what he has to pay upwards to the Executive Engineer. The corresponding figure for the Executive Engineer is probably more like three to five times." "Cement is a gold mine," Wade quoted one engineer as saying, "whenever cement content is more, it is more paying."

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known to have been created as comfortable sinecures for retired senior bureaucrats and High Court Justices politically appointed by the government. The Vigilance Commission's charge is to comment on the government's course of action and to recommend changes. The government does not have to accept the commission's recommendations; it can put the matter to a vote in the Legislative Assembly, where the ruling party or coalition has the majority by definition. (This is usually not necessary, because results of such inquiries are classified as "confidential" and are almost never released to either the public or the legislature.) Setting aside the circularity of these procedures, the Anti-Corruption Bureau, the Vigilance Commission, and the various federal agencies of similar lineage face prohibitive monitoring and detection costs, even if those activities were assumed to be their function. In reality, the agencies are politically created and subject to the same rent seeking as discussed earlier. Agencies, therefore, have been created to monitor the monitoring agencies, which expands rent seeking further still. Welfare losses thus increase substantially as the number of such government monitoring agencies increases.

Many economists (for example, Bauer 1981) have observed that everyday life is far more politicized in poor countries than in Western industrialized countries. Rent seeking, which is investment aimed at the governmental assignment of property rights, can lead to such politicization in a number of ways. Political jobs such as ministerships attract resources in the form of excessive political campaign spending and vote seeking. Returns to this form of entrepreneurship are highly uncertain, but the large magnitude of the rents lodged in political jobs make the expected payoffs attractive to many entrepreneurs. Because of the necessity for periodic elections, political jobs have limited tenure (unlike jobs in the civil service) so that these nonmarketable property rights are in fact rights to quasi-rents, and successful entrepreneurs have the incentive to appropriate their full value while in office. This usually implies disbursal of permits, licenses, and bureaucratic jobs to family and friends; approval of large-scale publicly funded projects that can be easily converted into personal wealth by theft and other means that are more difficult to detect; locating such projects in the minister's electoral district; and so forth.[12]

[12]Reports on these activities form the staple of journalism in India. A typical issue of any Indian news magazine is likely to devote the majority of its pages to such stories. The September 30, 1987, issue of *India Today*, for example, reported on the brothers-in-law of the chief ministers of Andhra Pradesh and Uttar Pradesh states who had enriched themselves considerably by appropriating as personal wealth public assets of substantial magnitude.

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Entrepreneurs who are successful in the political arena through majoritarian elections also face strong incentives to further bureaucratic growth in order to attract votes from unsuccessful job-seeking entrepreneurs (who far outnumber the successful) by alternative rights modifications. This takes the form of creating additional government bureaus and public universities with various constituency-based "quotas" for the newly created rent-access positions. These rents are partially funneled back into the political process through the financing of elections by public-sector bureaucrats, contractors, and suppliers. Besides the rent seeking that sets in for these new positions, previously unorganized groups also enter the political arena. The free-rider problem that obstructs the formation of many political interest groups in industrially advanced countries is less significant in a poor, regulated economy because the opportunity cost of time spent applying political pressure has been made low for many citizens. Widespread political activity among large and diverse sections of the populace, therefore, is commonplace.

When this is the only legally permissible mechanism for rights assignments for scarce government jobs, investment in political organization may be expected not only by those seeking to change rights assignments but also by successful entrepreneurs seeking to defend and augment the rents procured. This investment—which typically takes the form of political activity after successful rent capture—must also be counted as a welfare loss due to its detrimental effect on job performance: officials are distracted from performing such necessary functions of government as maintaining public law and order.[13] Thus, not only the unsuccessful but also the successful job-seeking entrepreneurs continue to engage in intense and continuous political activity in the form of agitations, public rallies, and threats of job nonperformance by government-sector unions made up of bureaucrats, university teachers, bus drivers, and so forth to extract salary increases and other benefits. Competition for governmental alterations in rights assignments thus sets in by rent defenders and by unsuccessful rent seekers for the creation of new property

[13]Jagganathan (1986, p. 128) gave the example of a typical farmer's plight: "If he wishes to sell his land, getting the deed registered in the local subregistry office . . . may involve a long wait. Even securing help from the police to simply enforce his rights when his house is burglarized is often an arduous task. Similar illustrations can be given indicating difficulties in securing the renewal of a motor vehicle license, obtaining a gun license or even a simple certificate of residence." Rashid (1981) has given an account of how operators in India's government-owned telephone monopoly act as individual discriminating monopolists arranging for international calls in order of the magnitude of bribe received.

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rights through the expansion of bureaucratic and political opportunities by tax increases and regulation of the private sector. Successful rights modification subsequently increases the incentives of unorganized interests to enter the political arena. These interests are then articulated in ways that are specific to the social-historical conditions obtaining in India.

Rent Seeking and Caste

Politics can enter different societies in different ways. The form of entry will depend on the specific institutions that determine the parameters of self-interest around which interest groups are created. In many parts of Africa, politics is defined along tribal lines, for instance, while it is primarily based on caste in India. The dogged persistence of caste and religious politics (not the class politics predicted by Marxist theory) has often been explained in terms of the hypothesis that the "false consciousness" of citizens blurs their vision about where their true interests lie (Chandra 1984). The rent-seeking explanation offered below makes quite the contrary claim: that it is precisely individuals' rational responses to existing institutions that generate the configuration of caste-based politics.

India has all the traditional special interest groups, such as trade associations, labor unions, and professional associations, but the predominant one continues to be caste. Castes in India bear the names of various occupations. Olson (1984, p. 156), who explicated the notion of castes as a system of guilds, has shown that historically castes have exhibited cartelistic features, including restrictive membership, price fixing, "professional ethics" (caste codes of behavior), group bargaining, and various rules limiting output and competition. Olson (p. 157) also observed: "With modernization many new occupations have emerged and the caste system has changed for other reasons as well, so the caste need not be primarily an occupational or guild-type classification for the educated Indian today." It is to be expected, then, that modernization would weaken the caste system by breaking the cartelistic features of different occupations and facilitating entry, but this has not occurred. Although intergenerational mobility into previously restricted occupations has certainly increased, many Indian social scientists have pointed out that caste and religious barriers have been simultaneously strengthened (Chandra 1984). Caste endogamy is the rule even among families whose members are now in occupations that have no relationship to their caste classification. While the guild explanation is a satisfactory one for the

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origin and evolution of the caste system, the question remains as to why the system has endured despite "modernization."

To this point, the analysis has suggested that when political control is gained by winning majorities in elections while the scope of the private economy has been constricted, interest group formation will be focused on capturing public revenues. This in turn will depend crucially on the *organizational costs* that have to be borne. The breakup of guilds depends on the incentives open to both guild members and outsiders to arbitrate between the guild price and the competitive price. Pervasive government regulation not only removes arbitrage incentives but also creates alternative incentives for the *strengthening* of these guilds even after the original guild-type functions have lost their significance. Insofar as capturing government resources depends on interest group formation, these old groups will not only continue to endure but also to gain in strength because the organizational costs for group formation have already been borne. Unlike the era of guilds in England, where the transition from the mercantilist to the market system was directly made, in India and many other newly independent countries the transition has been from a mercantilist system to one of government job/contract seeking. In such a situation, there is no economic incentive for the breakup of the original guilds.

This is reinforced by some traditional guild-type functions of castes that remain, especially in the case of the important landowning castes. These castes make the traditional lobbying-type rent-seeking investments to obtain subsidized seeds, credit, irrigation, electricity, fertilizer, inflated government-stipulated procurement prices for farm products, and so forth. These castes are occupation-based, and their activities fit the description of usual interest group activities. As Bardhan (1984, pp. 50, 52–53) observed, however:

> A major economic issue that divides them (the landowning castes) does not relate to agriculture or land interests at all: it is their access to jobs in the public bureaucracy. . . . The proportion of professionals coming from business, farmer or trading families has increased significantly. . . . No wonder that some of the bitterest caste struggles in various parts of urban India in recent years have been over the issues of reservation of seats in medical and engineering schools and of jobs in the government for lower castes.

Rent-seeking theory suggests that these caste conflicts have their roots in various constitutional provisions that are open to interest group pressure. The Indian Constitution is replete with such provisions (it is the most voluminous of any country), but a few that are particularly relevant bear mentioning. Article 15.4 allows the state

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to make "any special provisions for the advancement of any socially and educationally backward classes of citizens or for the Scheduled castes and Scheduled tribes." More specifically, Article 16.4 allows the state to make "any provision for the reservation of appointments or posts in favor of any backward class of citizens which, in the opinion of the state, is not adequately represented in the services under the state." Article 341.1 mandates that "the president may . . . by public notification specify the castes, races or tribes which shall for the purpose of this constitution be deemed to be Scheduled castes." And Article 341.2 adds: "Parliament may by law include in or exclude from the list of Scheduled castes specified under 341.1 any caste, race or tribe or any group within any caste, race or tribe." Articles 342.1 and 342.2 announce the same for the "Scheduled tribes." More than 1,181 different groups in the country have been labeled "Scheduled castes," more than 583 other groups as "Scheduled tribes," and roughly an additional sixth of the population is officially termed "backward." These provisions were initially to last for a period of ten years, but they were extended every 10 years and continue to the present day. Inclusion of different castes for these special provisions in the public sector depends on the political organizing ability of these groups. Thus, caste groups that have historically incurred the organizational costs may no longer have an explicit cartel function but they will continue to have the *political* function of seeking and maintaining favored consitutional status.[14] This implies that as long as widespread rent-seeking incentives exist, one can expect caste-based groups to be dominant in Indian politics. Only in the absence of such incentives will caste deviants find it profitable to break caste codes and enter restricted markets.[15]

The economic proposition that growth is a function of the "extent of the market" is as old as Adam Smith. When the market is widened

[14]*India Today* reported in its September 15, 1987, issue that in the southern state of Kerala, an angry mob of persons belonging to the Thandan caste beat up a village officer for refusing to issue them caste certificates (for preferential admission to local colleges and universities) because of their ambiguous constitutional status. The ambiguity stemmed from their different histories in different parts of the state: in the south they were traditionally coconut tree climbers, whereas in the north they were headmen chosen by the local chieftains. Political organizations for all the other "Scheduled Castes" had launched a vigorous public agitation against the issuance of Scheduled Caste certificates to the Thandans. The state government's response was to appoint a sociologist to head a commission that would "once and for all decide whether Thandans are Scheduled caste" (p. 31).

[15]It may be conjectured that the continuing endurance of tribal loyalties in the politics of modern-day Africa is also amenable to a rent-seeking explanation similar to the one offered here for India.

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through improvements in transportation, communications, and the removal of trade restraints, transactions costs for market participants are reduced and economic growth is accelerated. The integration of the early German and Italian states into nations, for instance, was economically beneficial because the tolls imposed by the various principalities were removed and the larger economic market came into being. By contrast, the creation of the nation-state of India (along political boundaries drawn by the British for colonial administrative convenience) was accompanied by the preservation of incentives for perpetuating caste-based interest groups centered on rent-seeking activities, thus leading to a narrowing of the economic arena and a concurrent widening of the political arena. This has created a situation where political entrepreneurs continually find it profitable to *increase* transactions costs among economic agents by segmenting the political market along caste and religious lines. This segmentation process intermittently explodes into deadly conflicts over government quotas for public sector jobs and for reservations in the medical and engineering schools.

Conclusion

This analysis suggests that "underdevelopment" is symptomatic of entrepreneurship being directed toward the production of outputs that generate no consumer surplus rather than any paucity of entrepreneurship as a factor production. In such a situation, governmental intervention only creates further rent-seeking opportunities and still further resource diversion into unproductive activities. The tax base in such a society is generated by the *losers* in the rent-seeking game who are forced into value-producing activity at governmentally depressed rates of return. These shopkeepers, cultivators, masons, carpenters, construction workers, agricultural laborers, and so forth are forced into market activity, and their consumption is then heavily taxed to meet the rent requirements of government job/contract seekers. With the reservation of most profitable sectors of the economy to government and the consequently restricted property rights in productive assets, investment opportunities available to successful rent seekers are also constricted, thus choking off any possibility for the rents to be invested productively. The rents procured, therefore, are usually invested in personal assets—such as automobiles, ostentatious housing, gold and silver jewelry, children's education, and savings bank accounts—in amounts that reflect individual marginal rates of substitution between current and future consumption.

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From this positive analysis emerges the normative question of identification and reform of the institutions that create incentives for entrepreneurs to capture rents embodied in the public sector rather than to engage in the production of goods and services that generate consumer surplus. Any proposal for reform must drastically reduce the magnitudes of these rents. While this may seem to imply steep reductions in government salaries and perquisites, such a step alone may only exacerbate the problem as officeholders try to compensate for lost income through increased bribery, extortion, and obstruction. The more significant component of the rents is lodged in the discretionary powers attaching to public offices. Especially important among these are the extraction of bribes for permits, licenses, and the awarding of government contracts; opportunities for theft of public assets; and threats of job nonperformance. As long as the present discounted value of these opportunities exceeds the expected returns from alternative economically productive employments of individual resources, economic entrepreneurship will be undersupplied and political/bureaucratic entrepreneurship will be oversupplied. Failing the drastic curtailment of these discretionary powers, rent-seeking losses will continue to be significant. Because such curtailment is unlikely, an alternative that would eliminate such welfare costs and simultaneously preserve these rents is to remove differential advantages by allowing equal access for all to the scarcity values, that is, by instituting an "equal sharing" rule (Buchanan 1980). To avoid individual resource investment for the purpose of shifting society from an equal sharing rule (if it were to be adopted) to some other rule, the former will have to be permanently and constitutionally embedded in all possible scarcity-value distributions. Operationally, the rights to such values will have to be assigned randomly in each case, which means that all the scarce government jobs and contracts will be assigned by a random lottery. If a system approximating random allocation were to be adopted, individuals would expend no resources to gain membership in some eligible set. Also, because the political process would then have little incentive to create additional rent-access offices, traditional price-distorting welfare losses would be reduced due to lower tax rates, rent-seeking welfare costs would be minimized, and the supply of entrepreneurship would equilibrate at its optimal levels in the economic and political/bureaucratic markets.

Although the theory of rent seeking dictates random allocation as the solution, it also predicts that it is the solution least likely to be adopted by the political/bureaucratic process. Any second-best solution, such as Jagganathan's (1986, p. 131) proposal that "instead of fixed charges and fees, a more flexible pricing system could be used

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based on the user's willingness to pay," is open to manipulation and information-concealment by the bureaucrat(s) charged with determining the user's willingness to pay for the service. How a transition to the theoretically best solution is to be effected remains an unsolved problem for normative rent-seeking theory.

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Revolution, Reputation Effects, and Time Horizons

Todd G. Buchholz

Ernest Hemingway said that "courage is grace under pressure." We would not expect a courageous or moral man to begin cheating, stealing, or looting when life gets tough. But not everyone is courageous, and few people, including lawyers and economists, appear particularly graceful. This article explores how people act under an extreme kind of pressure: the pressure of an imminent revolution that would likely transmogrify pre-existing legal rights and change the relations among persons. Let me reveal my conclusion first, before developing the model and attempting to apply it: as people begin to expect a truly radical revolution, the importance of reputation effects diminishes. For their reputation in the ancien régime will be irrelevant in the new regime. Thus, the society would see a decrease in the degree of cooperation, trust, and trade, leading to a rapid decline in the economy.

To portray the model, I will be using a few economic tools, including game theory and present value analysis. First, I will sketch a model that roughly depicts the choice between acting honestly and acting dishonestly. I will argue that the choice depends upon the present value of the expected benefits of the acts. Second, I will demonstrate that the time frame is extremely important in the decision process. Third, using the Prisoners' Dilemma framework, I will suggest that as revolutions appear imminent, we would see behavior that indicates a shift from the cooperative quadrant to the unilateral defection quadrant, and finally to the mutual defection quadrant. Fourth, as an empirical case, I will make a preliminary examination

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of the behavior of residents of Saigon, South Vietnam in April 1975, when the North Vietnamese invaded.

Is Honesty the Best Policy?

A Present Value Model

With due respect to Immanuel Kant and one's Sunday school teacher, honesty is not always the best policy, if one's goal is to maximize material benefits. Happily, honesty usually is the best policy to maximize both moral and monetary matters. Two forces dissuade even amoral egotists from cheating or stealing, especially in business. The first, the fear of being punished by the law. The second, the fear that a bad reputation will repel others from dealing with them in the future. The key phrase in the last sentence is "in the future." The model must, then, posit a choice that considers future and present benefits. A modified version of the familiar present value equation shown in equation 1 works rather well:

$$\sum_{k=0}^{t} \frac{(1-p)\,(Bd)}{(1+r)^k} = \frac{(Bh)}{r}, \qquad (1)$$

where p is the probability of being punished by the law, Bd is the benefit of dishonesty, r is the discount rate, t is the number of transactions (years), and Bh is the benefit of honesty.

Each of these variables is crucial to the decision. Essentially, this model suggests that economic actors will act as if they assess the probability of getting away with dishonest acts. They then consider the future and discount to the present the benefits of acting dishonestly. The left side, or the sinister side, of the equation is compared with the right side of the equation, which gives the present value of honest acts. Let us examine the variables and see why honesty is usually the best policy. If the probability (p) of being caught is high (so that [1-p], the probability of succeeding in the dishonest act, is low), the benefits of dishonesty are obviously diminished. If the discount rate (r) is high, the value of the future benefits is diminished. If the number of transactions (t) is high, the value of future benefits is increased.

Notice that the right side of the equation is discounted by r. There is no t term, which makes the formula a perpetuity. That is, the fraction calculates the present value of a particular benefit if it is received each year forever. For example, \$100/.10 = \$1,000 indicates that \$1,000 is the present value of receiving \$100 forever when r = 0.10. Why is the left side of the equation not a perpetuity? I assume

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that because of reputation effects, a dishonest businessman could not get away with dirty tricks forever. The factor t represents the length of time it takes before he is made a pariah. Contravening Abraham Lincoln, I presume you cannot fool even some of the people all of the time. Only honest acts can be performed in perpetuity. The model is, of course, simpler than it could be, if we considered other factors. For instance, we may want to include a growth term on the right side of the equation, indicating that honest business brings in more business, that is, positive reputation effects or goodwill. Thus, the right side could be written (B/r-g). We could also add a growth term with a positive sign to the denominator of the left side to indicate the added likelihood of being exposed or apprehended after committing dishonest acts. Furthermore, we could modify the numerator of the left side by considering the punishment received when apprehended. Equation 1 assumes only that apprehension or exposure ends one's participation in transactions and results in restitution of the loot robbed in only the last act, rather than additional punitive damages. Nonetheless, the simple model portrays the most important general factors without forcing us to specify the particular dishonest act in question. Our present value model is not specified as comprehensively as other models of criminal behavior devised by Ehrlich (1973) and Becker (1968), for example. But the goal here is not to prove how the individual may maximize income subject to constraints. Instead, the goal is to show how important the time factor actually is. I assume that p, which has two components, the probability of apprehension and the probability of being exposed, is a positive function of t.[1]

How can we apply this model? Assume that a dishonest man, Iago, will buy an item wholesale on credit and then resell the item for $100, keeping the gross revenue and then hiding from the wholesaler. He "earns" $100. The honest man, Othello, who also buys from the wholesaler, will resell at a profit of only about 10 percent, or $10. Further, honest Othello could sell an infinite number of items. If the discount rate is 3 percent, the present value of honesty is $333.33. What is the present value of dishonesty? We must know how many suckers there are. Assume no policemen and that the dishonest man finds one sucker each year for four years, before his reputation precedes him. Dishonesty pays. For in present dollars Iago would expect to earn $100 in the first year, $97.10 in the second, $94.30 in the

[1]I recognize the conflation of time with the number of transactions. The variable r should not necessarily indicate the annual interest rate but the discount rate applied to future transactions, whether they are next year or after lunch today.

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third, and $91.50 in the fourth. The total equals $382.90. Even if the honest man sells an item each year for a million years, dishonesty on four occasions has a higher present value. If we say that the probability of apprehension equals 50 percent each time, Iago would have to succeed eight times.

Since reputation effects limit the evil acts, making dishonesty a short-run strategy, an increase in the discount rate, which reduces future benefits, affects honest Othello more than Iago. For instance, if r grows to 0.10, Iago need steal only once to equal Othello's perpetual honesty.

Why does honesty usually pay? (1) Apprehension rates through civil remedies or criminal penalties are significant; (2) discount rates per transaction are usually low; and (3) businessmen tend to imagine at least large and uncertain, if not perpetual, turnover.

Notice that the curves in Figure 1 cross very quickly, after only the Xth transaction or time period. The short-run strategy might also be exploited by a person who gets out of the dishonest business quickly, for example, by selling his business to a bona fide buyer in good faith who assumes that the past profits came licitly and that future licit profits will follow. In a classic tax shelter fraud, a shady entrepreneur sold his stake in cattle herds to a truck leasing corporation, which later found itself in bankruptcy court, as well as civil court, to defend against the fraud perpetrated by the entrepreneur. The short-run strategy worked even more quickly and efficiently than even the entrepreneur had planned—he died not long after selling his stake for over five million dollars.[2]

What happens if a revolution becomes imminent that is so profound that it will twist future property arrangements and legal rights? Obviously, with increased uncertainty, the discount rate would rise and the probability of apprehension or punishment after the revolution would decline. Clearly, South Vietnamese capitalists would not knock on the doors of their new communist judges and claim that peasants owed them financial capital from before the revolution. More dramatic than these effects, though, people would shrink their time frames and consider the future to be a finite period. If $t = 4$, whereas it used to be infinite, the benefits of dishonesty overwhelm the benefits of the previous probity. Reputation does not matter as the Huns come riding over the hills with swords drawn. Hobbes said that before government, lives were "solitary, poor, nasty, brutish, and short." He was probably empirically wrong. Furthermore, he was theoretically wrong, for even if p in our equation is small, if t is

[2]See Ingenito v. Bermec Corporation et al. (1977) and Penn (1976).

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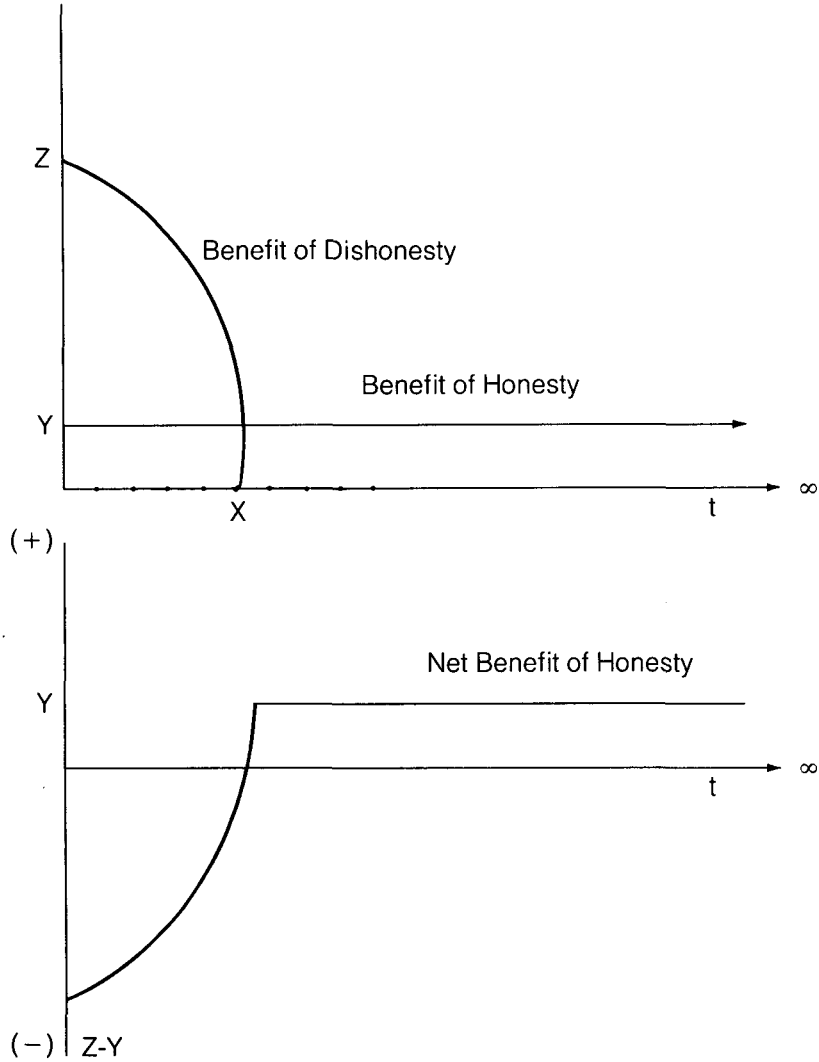
FIGURE 1

A PRESENT VALUE MODEL OF HONESTY



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large enough, reputation effects matter a great deal, and people will have good reason to cooperate. Only if time frames shrink severely (or if cooperation yielded no benefits), would the Hobbesian nightmare seem valid.

What kind of behavior would we see if this hypothesis is correct? We can consider this from different perspectives. If invaders or revolutionaries will expropriate property and extinguish legal claims, we should see both ex ante and ex post changes in behavior. The ex ante changes would include, for example, a reduction in contracts, a decrease in the extension of credit, and a rise in crime. Ex post effects would include breaching contracts and refusing to pay back loans, for instance. These kinds of results severely contract an economy. Since the slope of the dishonesty curve is so steep, the economy should collapse rather briskly once enough people shrink their horizons. Thus, when revolution is imminent, we should not see a gradual economic decline, but a swift response. The kind of revolution is surely important. The most piquant examples are those in which commercial economies are replaced by totalitarian or noncommercial authoritarian regimes as in Vietnam and Iran. The effects of bourgeois revolutions on pre-industrial economies would be different and perhaps minimal.

Although I focus on revolutions, this framework has more general applications, for whenever time frames shrink, choices are affected. Similar effects follow when a subset of the population faces expropriation or deportation. Both the victims-to-be and nonvictim bystanders will shrink their time horizons—except that the bystanders will shrink their horizons only with respect to the victims. Robert Axelrod (1983, p. 328) quotes Caesar on Pompey's allies: "They regard his prospects as hopeless and acted according to the common rule by which a man's friends become the enemies of adversity." How do people treat aliens who will be deported? The treatment of Jews by many citizens during World War II would suggest that certain deportation often enhances and ensures victimization prior to the departure (see Dawidowicz 1975). The performance of laborers for impending bankrupt firms would provide another example, along with the treatment by customers of imminently bankrupt manufacturers.[3]

Remember, however, that even if the bystander will not have future contacts with the victims, others will see how he treats victims.

[3]See, for instance, Mayer (1980, p. 280): "once a manufacturer begins to go under, even his best customers begin refusing payment for merchandise, claiming defects in quality, failure to meet specifications. . . ."

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Thus, reputation effects are not entirely eliminated. One who quits a job often does so politely, so that he may have a reference for a future employer. Society has many institutions to gauge reputation, including credit reference companies. Of course, the information available may not be helpful or applicable in all contexts. If a potential creditor calls American Express, for example, the credit card company may reveal that Othello is generally creditworthy, but it will not tell how he performs when barbarians invade or when he is infected by jealousy, that is, radical revolution presents a different scenario.

A Game Theoretic Framework

Before applying the present value model, I will place it within a game theoretic framework. The standard Prisoners' Dilemma model shown in Figure 2 can be fitted with the following values to match the previous discussion: quadrant (1), mutual cooperation, each

FIGURE 2

THE PRISONERS' DILEMMA

IAGO \ OTHELLO	Cooperate	Defect
Cooperate	(1) 10, 10 mutual gain	(2) −100, 100 Othello wins
Defect	(3) 100, −100 Iago wins	(4) 0, 0 mutual defect

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receives profits of 10; quadrant (2), successful defection by Othello, who receives 100 and Iago −100; quadrant (3), successful defection by Iago, who receives 100 and Othello −100; and quadrant (4), mutual defection, each gets 0.

Because time horizons are generally long, the economy benefits from mutual cooperation and trade. The law of comparative advantage is exploited, and the economy is extroverted rather than insular. The economy settles in quadrant (1). Although some cheaters exist, they do not invade the system, since legal restraints and reputation effects prevent them from continually playing the game and defecting.

If the time horizon shrinks, however, more players are tempted to defect, since successful defection pays. The economy first moves to either quadrant (2) or quadrant (3). But soon defectors arouse enough suspicion that even the categorically honest might defect just to protect themselves against loss. More likely, though, those who would not defect because they listen to Kant or their Sunday School teachers will simply cease to engage in market transactions that cannot be accomplished contemporaneously and with full information. In either case, an economy in which only short-term decisions and contracts can be engaged in cannot grow and will certainly shrink from a more developed state. The model need not assume that people weigh costs and benefits—only that they act as if they do.

Through the shrinking of the time horizon, we move from an infinite series of games to a finite series of games. As Luce and Raiffa taught (1957, pp. 94–102), when egotists play a finite game, there is no incentive to cooperate. On the last move each will defect. Thus, on the next to last move, there is no incentive to cooperate for the sake of future expectations. Therefore, each will defect on the next to last move. And the process unravels back to the first move.

Following the lead of inventive mathematicians, some social scientists have attempted to use the catastrophe theory apparatus to model certain social events. If we played out the above scenario, the shift from quadrant (1) to quadrant (4) would show a catastrophic path. An economy can move back and forth between higher and lower discount rates, with gradual effects on the level of economic activity, if t remains infinite and p remains high. Even if p falls, reputation effects will help maintain order and economic activity if t remains high (although a decrease in activity would still occur). But if t falls, the economy collapses and tumbles out of what Axel Leijonhufvud (1973) calls the "corridor of stability." Possibly, this could be avoided if p approaches 1. However, if t falls, p would likely plunge also, for the discipline of police and court systems also depends on reputation

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effects. Therefore, as t decreases, a catastrophic path begins and the economy collapses.[4]

In sum, an expectation that revolution will overwhelm a previous regime should lead to economic collapse, through a catastrophic recoiling of the time horizon, a decrease in the probability of apprehension and, to a lesser extent, an increase in the discount rate.

An Empirical Case: Saigon, Vietnam

In applying the model to a historical situation, we face insurmountable obstacles. In particular, although econometric models can estimate how important apprehension probabilities are to the crime rate, it is impossible to specifically attribute economic behavior to the time horizon factor. As stated above, there is a relationship between p and t. To some extent, p is determined by t (reverse causation is also plausible). During a revolution, a confluence of smaller time horizons and lower p rates takes place. In econometric terms, we have a multicollinearity problem, making isolation of independent variables extremely difficult.

The clear and present danger of a radical revolution, through a shrunken time horizon, injures all societal tools for enforcing promises and promoting benevolent behavior, including reputation effects and civil laws. To assign specific values to reputation effects is too ambitious a task even for this project. Nonetheless, we can say with surety: nobody likes to be an unrequited seller, lender, or lover. Radical revolutions usually lead to bankrupt firms and broken hearts. To avoid these pains, prudent individuals will try to avoid initial performance of economic acts, as well as other sorts.

My intent for an empirical case is modest. I wish only to describe why Vietnam presents a good test for the hypothesis and to suggest behavior indicative of the hypothesis.

Several other countries might provide powerful support for my hypothesis, including Iran and Lebanon. Yet these revolutionary regimes with their embattled warlords release little factual evidence to the public, especially evidence that would impeach their administrative prowess. Though similarly fractured, Vietnam of 1975 allows for a better case study, because Western reporters and officials maintained their posts until the final, dramatic moments of overthrow and because the revolutionary forces arrived with warning rather than in a sudden coup d'etat.

One other example may truly test this model in the coming years: Hong Kong. So far, the government of China promises to keep the

[4]On catastrophe theory, see E. C. Zeeman (1977) and Balasko (1978).

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capitalist territory free of communist rule after Britain relinquishes control in 1997. Serious doubts about China's honesty would quickly encourage capital flight as well as human flight. Should China appear to break its word, not only would it lose face, but it would also lose a potent engine of economic growth located on its shore.

In early January 1975, the North Vietnamese forces launched a massive campaign, the Ho Chi Minh Offensive. By mid-March they conquered most of South Vietnam. Refugees came streaming southward, 100,000 of them jamming the city of Hue. And by the end of the month, half a million stragglers and fugitives descended on Da Nang, South Vietnam's second largest city—located 370 miles northeast of Saigon. So frightened were refugees that those with access to motor transporation could charge up to $1,200 to drive people southward. However, government propaganda still persuaded residents of Saigon that they were safe from attack. As April proceeded, the situation looked worse. Saigon's vulnerability seemed apparent when a renegade pilot bombed the presidential palace on April 8th. In mid-April, U.S. Secretary of Defense James Schlesinger testified before Congress that over 200,000 South Vietnamese would be endangered if the Communists took over Saigon. The report appeared in Saigon newspapers the next morning, making more vivid the nightmares of atrocity and plunder that refugees were telling frightened residents.

The military situation continued to deteriorate. Finally, on April 29th and 30th, 1,400 Americans and 5,600 South Vietnamese were airlifted out of Saigon, just as North Vietnamese troops approached. During the month of April well over 100,000 South Vietnamese left their country. Many more tried desperately yet unsuccessfully. One of the last Americans out reported seeing from a helicopter "along the spiderweb of highways leading in . . . literally thousands of [North Vietnamese] trucks and tanks . . . inching their way forward, their headlights blazing . . ." (Snepp 1977, p. 453).

The scenario provides a good test case. Few contemporary examples would exhibit such a shrinking of time horizons. First, many residents of Saigon expected a violent confrontation in their city in which the Communists would win. Many tried quixotically to flee. Even if they would not be faced with violence, they surely would have property rights critically changed. Many expected both, for they had heard of the North Vietnamese land reform of the mid-1950s, which left 30,000 to 50,000 intransigent peasants and landowners dead or imprisoned.

How did the Vietnamese act under excruciating pressure? We can see both social and economic responses. The economic responses are not well documented. As early as 1974 banks became reluctant

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to make new loans, and small and medium-sized businesses resisted new investment. By early April, residents scrambled for cash and liquidity, inciting chaotic scenes at banks. The government-linked Credit Commercial lost more than 70 percent of its deposits in a week (although this includes losses from branches taken over by Communists); local banks averaged a 40 percent loss. Even foreign banks lost 14 percent. According to the *Far Eastern Economic Review* (1975), the panic was staunched not by a vote of confidence, but by a feeling that collapse was not necessarily imminent. At the height of panic, the black market rate soared from 900 piastres to 1,800 per dollar (official rate = 700). Later it reached 3,800. Credit cards and travelers checks no longer were accepted. The First National City Bank at one time refused to honor even its own travelers checks!

The rapid switch in currency seems to indicate an ex ante abandonment of the Vietnamese economy and a drive for liquidity. As a switch to dollars was made, a significant jump in velocity of the piastre followed, confounding anti-inflationary policy (Dacy 1986, pp. 140–49). Not long before, the government abandoned short-term treasury bonds and offered long-term bonds at real interest rates of about 0 percent. I do not have reliable data on how well the bonds sold. It appears that government instruments yielded far lower rates than private instruments. In the years preceding April 1975, nongovernment affiliated lenders charged a real interest rate of about 20 percent. Surely, this would be a minimum for the real interest rate at the end of April (United Nations 1976, pp. 43–57).

The conversion to dollars did not signal that the Communist government would use dollars as their currency. Instead, dollars were used to pay for transportation away from Vietnam. Vietnamese barge owners charged from $5,000 to $10,000 in cash. It would be interesting to know whether anybody paid in advance and was left waiting on the dock.

The situation continued to deteriorate. Frank Snepp (1977, p. 273) writes: the "malaise at the top levels of government was matched by a growing sense of defeatism throughout the society." By mid-April, "the thieves' market . . . had become a cornucopia of discarded luxury. Iceboxes, stereos, air conditioners, anything too large to fit in a suitcase could be had for a third or a fourth of the usual bargaining price . . . beautiful old French villas were being boarded up and abandoned as their owners departed precipitously, often without making a sale."

People who would not have bribed before, did. Under-the-table gratuities for a passport reached $3,000 in two weeks in early April, and the legal order began to crumble. U.S. officials had to pay over

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$50,000 in bribes to South Vietnamese police and military personnel to ensure the evacuation of Vietnamese. Most pathetic, a young economist for the Deputy Premier asked an American friend to marry his three-month pregnant wife. He would pay $10,000 (*New York Times* 1975). The CIA station chief reported that the agency lost over five million dollars worth of equipment from the Saigon office in just two weeks.

Looters and army stragglers broke into the British and American embassies, while government soldiers began to desert units, engage in thievery, and sneak aboard airlifts intended for civilians. According to newspaper reporters, thousands, including civilians and police, stripped the apartment building where U.S. officials lived. In Da Nang, "a good number of the city inhabitants" joined South Vietnamese soldiers in "incredible" looting during the last "hours of madness," reported the director of the French Cultural Center. In other towns, commercial life quickly ceased (*The Times* [London] 1975).

Even the nation's chief economist, Economics Minister Hao, broke the law. The United States tried to persuade South Vietnam to deposit its gold reserves—worth $220 million—in the name of the country in the New York Federal Reserve Bank. Government officials agreed. But the Communists told Hao in early April that he would be treated leniently if he prevented the gold from leaving. When the North Vietnamese arrived, the gold was sitting in a cargo room. According to the CIA, Hao was not a Communist nor a Communist agent. But he did believe that the North would win, and he was willing to cheat the South.

The final scene on April 29th was chaotic. The population ignored the 24-hour curfew and all residents frenetically took to the streets. The U.S. ambassador's aide described "cars and trucks . . . hurtling everywhere. Blind old mama-sans and panicked army officers . . . behind every wheel" (Snepp 1977, p. 391).

None of the hellish scenario proves the model. Much of the law breaking can be attributed to a reduction in the probability of being apprehended for illegal acts. But what caused this probability to fall? Why did policemen renege on their civic duties? I submit that the shrinking of time horizons heavily influenced the incentive to monitor illegal behavior.

Data on breaches of contract, repayment of debt, and whether anybody continued to engage in long-term transactions would be very helpful. A conclusion on reputation effects in South Vietnam cannot be reached yet. But the evidence so far seems suggestive.

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Conclusion

My hypothesis does not explain why revolutions take place, nor precisely why time horizons shrink. It simply asserts that when time horizons shrink, the economic effects are likely to be severe and rapid. Some wit once remarked that socialism is no good because it takes up too many evenings. According to my model, the more evenings we think we have, the more social we will be.

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It's Time to Free the Mails

James C. Miller III

Suggest that mail service might be improved by ending the government's monopoly over the delivery of letter mail, and most postal officials react as Oscar Wilde reacted when a producer suggested changes in one of his plays. Wilde clutched his manuscript in mock terror and exclaimed: "Changes? Impossible! Who am I to tamper with a masterpiece!"

To its friends, at least, the Postal Service *is* a masterpiece—a marvelous mechanical toy, performing its functions with clockwork regularity and precision. Admittedly, the machinery breaks down every now and then, but it takes only a little tinkering—or a modest increase in the price of a first-class stamp—to put things right.

But this argument is wearing thin. Mounting criticism of the Postal Service has forced its apologists to make more convincing excuses. Increasingly, they have tried to lay the blame at other doorsteps—including mine. Incredible as it may seem, OMB is being blamed for what's wrong with the Postal Service today. Let's look at these allegations, and then let's look at the facts.

Postal Service Blames OMB

First, OMB is accused of trying to "micro-manage" the U.S. Postal Service. Now how in the world can we do that? OMB has no apportionment power over the Postal Service. Nor have we authority to approve or disapprove the Postal Service's budget submissions to Congress. Nor have we any control over the Postal Service's legislative proposals. Nor over its testimony. Nor over its personnel. Nor over the rules and regulations the agency promulgates. So where do

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the friends of the Postal Service get this notion that OMB is trying to "micro-manage" the agency?

Second, in response to public outcry over cutbacks in window hours and collections, friends of the Postal Service have alleged that OMB is responsible for these inconveniences. Vincent R. Sombrotto, President of the National Association of Letter Carriers, said in a recent letter to the *Wall Street Journal* (5 April 1988): "The serious cutbacks were engineered by OMB Director James Miller III." But if OMB has no direct control over the Postal Service, how could this be true?

Of course, the friends of the Postal Service have a ready answer to that one as well. If OMB has not dictated precise cutbacks, they say, we have "forced" the savings that are making the cutbacks necessary. For example, Moe Biller, President of the American Postal Workers Union, AFL-CIO, said in a recent letter to the *Washington Post* (2 April 1988): "[R]ecent Postal Service reductions . . . have been imposed by budget cuts engineered by President Reagan and his hatchet man—Budget Director James Miller III."

Let's be very clear on this point: when we concluded the bipartisan budget negotiations last November, it was understood that the House Post Office and Civil Service Committee, in cooperation with the Senate Governmental Affairs Committee, would pony up $850 million in outlay reductions for each of the two years covered by the agreement. OMB's role in this matter was not to dictate where the savings came from, but whether they could be "scored"—or, in other words, realized.

Predictably, the Postal Service played the "Washington Monument Game." It shortened window hours 10 percent; it stopped collecting mail on Sundays; and it eliminated the Sunday sorting of outgoing mail. A letter-writing campaign has been launched. Organized labor is running ads. The avowed object of this propaganda barrage is to end the alleged "micro-management" of the Postal Service by the executive branch.

The real object, however, is more disturbing. What these people want is nothing less than the elimination of effective Congressional oversight and exemption from budgetary discipline. In plain terms, they want to put the agency "off budget." They don't think that the federal government's need to reduce the deficit should affect them in the least.

Well, we'll see about that. The postal unions have long been accustomed to getting their way with Congress, but do they really think that Congress is going to roll over and play dead on this one? Do they really think the administration is going to stop looking at ways

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by which improved mail service might be provided at lower costs? Now, I can't speak for Congress, but I can tell you that the answer up at our end of Pennsylvania Avenue is, "Not on your life!"

Private Alternatives to Postal Cutbacks

So what's to be done about the Postal Service? First, let's address those cutbacks in service. Believe it or not, those drastic cutbacks I just cited are being blamed on a reduction in operating expenses of less than *1 percent*! Less than 1 percent! Whom does the Postal Service think it's kidding? And this is not to mention the other cutbacks they claim they are being "forced" to make. Doesn't the Postal Service realize that, on average, American industry reduces costs by almost 2 percent every year? Why can't the Postal Service do the same?

Rather than close windows, let mailboxes fill, and allow sorting tables to groan under the weight of unsorted letters over the weekend, the Postal Service ought to consider the suggestions for savings made by the General Accounting Office, the Grace Commission, the Privatization Commission, numerous academic studies, and the U.S. Postal Service itself.

For example, the Postal Service should contract more with retail stores for the sale of stamps, the posting of parcel post, and the acceptance of express mail. The public would have more postal windows without the need to build more post offices. The Postal Service should contract out larger volumes of mail to private firms for presorting. Today, some 40 percent of first-class mail and 50 percent of third-class mail is sorted, not by the Postal Service, but by private industry. The Postal Service should expand the practice of contracting out rural mail delivery to private carriers. And so on. We estimate that these and other creative new approaches to mail service would more than cover the required savings and reductions in operating costs mandated by Congress in last year's Reconciliation Act.

So much for the immediate problem; what should we do about the Postal Service over the longer term? Here I would agree that the Postal Service should be placed off-budget. But I think we should place the Postal Service off-budget by making it part of the private sector.

The Postal Service has been an independent corporation for nearly 20 years. There is no good reason why it should remain part of the U.S. Government, and no good reason why it should enjoy a monopoly over the delivery of letter mail—anymore than a single company

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should enjoy a monopoly over such services as banking, insurance, or telecommunications.

But the Postal Service and the postal unions want it both ways. They want to be an independent corporation when it comes to the budget process, but they feel they should be exempt from the belt-tightening required of every other federal agency, including the Department of Defense. At the same time, they want to be a government-protected monopoly when it comes to letter mail, and they want to be a federal agency when it comes for federal subsidies and other federal benefits. For example, they want to retain the taxpayer payment for revenue foregone ($650 million in FY 1987), and subsidies for the unfunded portion of Federal retirement and health benefits ($2.5 billion in FY 1987). They also want to retain access to the Federal Financing Bank, which gives the Postal Service a 1 percent interest advantage, worth over $100 million in FY 1987.

A "Necessary" Monopoly?

Advocates of the present system make the classic monopolist's defense: necessity. If there were no postal monopoly, say the postal monopolists, nationwide delivery of the mail would be left to the caprices and uncertainties of the free market. Mail service would no longer be reliable. Amateurs and sharpers would move in. The business community would be hampered in its ability to transact business by letter. The economy would suffer. People would be laid off. Calamities untold and manifold would befall the Republic!

As an economist, I am skeptical of this argument: have these people never heard of United Parcel Service or Federal Express? If you push them on this point, they'll usually come back with the familiar "cream skimming" argument. Yes, they will say, United Parcel and Federal Express are all very well—in their place. But the delivery of letter mail is a special situation. If private carriers were permitted to compete for the delivery of letters, competition would be intense for the most profitable routes—i.e., those in highly populated areas—but thinly populated rural areas would be slighted or ignored. Since the Postal Service would be squeezed out of the more profitable routes, it would not be able to take care of the hinterlands. Great-Aunt Gertrude, who lives way up in Lonesome Valley, Montana, would no longer receive cards on Christmas and her birthday.

This argument is likewise unpersuasive. In point of fact, it has always been the private sector that has taken the lead in providing cheaper, faster, and more convenient mail delivery. And it has been

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the Postal Service that, more often than not, has impeded these efforts by invoking its legal monopoly.

If the Postal Service is really worried about Great-Aunt Gertrude and the other patrons who live on what are supposedly "unprofitable" routes, why won't it allow competition in those markets as the Privatization Commission recommends? Why won't it allow competition in the delivery of "junk mail"—another recommendation of the Privatization Commission? Is it *that* afraid of the energy and creativity of the private sector? Perhaps it is. After all, if private letter carriers can make money off the "milk"—letting the Postal Service "skim the cream"—then there is no longer any convincing argument against total privatization of the mails.

How to Privatize the Postal Service

All fears to the contrary notwithstanding, the Postal Service could survive and even prosper as a private corporation once all government controls were removed. But it would have to be truly private and able to compete on equal terms with other mail carriers. As long as the Postal Service remains a governmental entity, it cannot adjust its rates without lengthy administrative hearings; it cannot close unprofitable post offices or otherwise restructure its operations without risking the wrath of Congress; and it cannot tie pay to performance and make needed staffing changes because of the political clout of the postal unions. Thus, simply to repeal the private express statutes and allow private companies to compete with the Postal Service would be both unfair and uneconomical. First the umbilical cord to the Federal Government must be cut, and I believe this can be done.

Recently, two of my OMB colleagues and I visited with a number of political leaders and privatization experts in Europe. They told us that their public-sector commercial operations have done very well when transferred to the private sector. One reason is that they have given employees a stake in the outcome. What they did was to give each employee a block of stock and incentives to purchase more. The result was that while the employee unions opposed the idea overwhelmingly, the employees took full advantage of stock ownership. On the whole, we were told, these experiments were a great success. I think we should do something like that here with the Postal Service. The Privatization Commission, in fact, made just such a recommendation.

There is no good reason why this recommendation should not be implemented. The fundamental arguments for and against ending the postal monopoly have not changed in a century and a half. But

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by this time the accumulated evidence is conclusive: the privatizers and anti-monopolists have won the debate hands down. Practically all the great innovations in mail delivery have come from the private sector while the Postal Service, at best, has tried to catch up or, at worst, tried to stand in the way. We can now assert with confidence that the public has everything to gain from competition and little, if anything, to lose. In fact, the only losers I can imagine would be the cartoonists—who would no longer be able to get away with caricaturing the Postal Service as a giant snail.

Victor Hugo once said that nothing can withstand an idea whose time has come. I say it's time to free the mails!

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COMMUNICATIONS

On Interpreting Keynes: Reply to Leijonhufvud

Leland B. Yeager

Professor Leijonhufvud's writings have taught me much over the years, which helps explain why we now find ourselves largely in agreement. True, we still need to discuss some issues. In what macroeconomic ways were the circumstances of coin shortages and of the Irish bank strike similar or different, and what implications follow? Does Austrian business-cycle theory really perceive overinvestment (as opposed to malinvestment) in the boom? How well warranted is emphasis on real cycles? (I infer that Leijonhufvud does not intend to deemphasize money as much as the term "real" might suggest.) In a world plausibly called "monetarist" (even if different from our actual world), would people indeed promptly know, after a disturbance, the new prices necessary for equilibrium?

Here, however, I shall consider only Leijonhufvud's (1986) defense of his and Robert Clower's interpretation of "what Keynes really meant in the *General Theory*"—a rather vague (and, as he says, belated) defense against questions raised by Herschel Grossman (1972) and me (1973). Subsequently discovered material, Leijonhufvud says, "leaves absolutely no doubt whatsoever" that the Clower-Leijonhufvud interpretation of Keynes is correct; "we now do know precisely what he meant." (Here Leijonhufvud mentions Clower's interpretation of the consumption function in particular. Is he now narrowing the scope of the challenged interpretation?)

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Leijonhufvud's style of argument might well be named "proof by emphatic reassertion." As evidence of what we now know "precisely" and with "absolutely no doubt whatsoever," he offers nothing more than a sweeping reference to "outlines and drafts of introductory chapters (pp. 63–102) [62–102, actually] that Keynes eventually discarded in favor of his brief and cryptic Chapter 2" of the *General Theory*. This material appeared only in 1979 in volume 29 of Keynes's *Collected Writings*.

In an article of 1983 (p. 198, footnote), Leijonhufvud did say a bit more about this material (found in the "Tilton laundry hamper"). Keynes, he notes, contrasts a Co-operative Economy, in which "labor is bartered for goods, so that the supply of labor is always an effective demand for goods," with an Entrepreneur Economy, in which exchanges take place only through the intermediary of money, making effecting demand failures and involuntary unemployment possible. "That," Leijonhufvud thinks, "should settle the matter."

What else do we find in the cited pages of volume 29? Keynes worries about the possibility, even likelihood, that effective demand exercised out of factor incomes will not suffice to buy, at cost-covering prices, all the output produced by the income-earning factors. Following Marx, he notes that business firms are not engaged in exchanging goods and services for money in order to obtain other goods and services. Rather, they are parting with money for goods and services in order to end up with more money than they started with. Keynes makes another good point (page 98): ". . . an individual producer is not interested in the smallest degree in the level of real wages. He does not, in his business capacity, even enquire what it is. He is solely concerned with the prospective selling price of his own product relatively to his variable costs."

Keynes makes various stabs at describing arrangements that *would* ensure adequate demand. The simplest would be to pay factors in shares of the actual output produced. Another possibility is paying factor incomes not in money but in dated counters that became worthless if not spent on current output of finished goods by the date stamped on them.

Our existing system is prone to deficient demand and unemployment, Keynes says. But the opposite bias, proneness to excessive demand and overemployment, is conceivable "if the means of remuneration would 'keep' *less* readily than the output." (P. 87. This remark seems to allude to the supposed stimulatory effects of money undergoing chronic inflation or to a tax on holdings such as Silvio Gesell proposed.)

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In these discarded draft pages, as in so much of the *General Theory* itself, Keynes worries about a chronic, systemic tendency toward deficiency of demand. He does achieve glimpses, sometimes more and sometimes less cloudy, of the essentially monetary nature of the supposed difficulty. (Pages 85–86 contain remarks reminiscent of what did get published in chapter 17 of the GT.) In a disorganized way, he makes repeated stabs at trying to say what he means—or at trying to figure out for himself what he means. (I am not criticizing Keynes. Leijonhufvud has referred us to rough draft not intended for publication.) What Keynes does say here is not necessarily inconsistent with what he explicitly and repeatedly says in the GT about deficiency of demand being rooted in *real* factors. Parts of these draft pages might alternatively be interpreted as consistent with a monetary-disequilibrium theory of miscoordination and of piecemeal, long-drawn-out groping toward a new state of coordination after a macro disturbance.

But Keynes did not articulate any such theory; and if he had it "at the back of his mind," he had it only in a fuzzy, rudimentary version. Certainly he did not come close to the theory of miscoordination that was stated clearly by many writers in the monetary-disequilibrium tradition. It remains true, then, that the Keynesian Revolution was a *diversion* from the path of progress in money/macro theory.

Even if—which I dispute—even if the laundry-hamper drafts did clearly support Clower's and Leijonhufvud's interpretation of Keynesianism, the fact would still remain that those authors had, when writing their exegeses of the GT, been "reading not so much between the lines as off the edge of the page" (Coddington [1976] 1983, p. 227). (There is such a thing as being right on a scientific or scholarly issue by mere accident.) Furthermore, what significance attaches to what Keynes said or supposedly said or supposedly meant in rough drafts that he *discarded*? The fact that he wrote certain ideas down, considered them, and then *discarded* them would suggest that they were *not* what he meant.

No one should blame Keynes for error. Excessive fear of error blocks ever accomplishing anything. But to serve the integrity of the history of economic thought and also the very substance of money/macro theory, is it not time at last to give up the delusion that Keynes really had this theory right all along?

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Did Keynes Mean Anything? Rejoinder to Yeager

Axel Leijonhufvud

Professor Yeager may be justified in his complaint that I have defended my interpretation of Keynes of 20 years ago merely by "emphatic reassertion." I have tried consistently to refrain from rearguing my case, when I have had nothing much to add to it, in response to the various commentaries and criticisms that have been raised against it. Repetition of that sort has seldom proved productive. At some point, one must simply leave it to readers to make their own judgments without boring them with one's insistence on having been right. When Yeager alluded to the matter in his recent paper, I wished merely to signal that I do not concede to his critique (or very much to Grossman's). But this time, there also was something to add, namely, the previously unknown evidence from Keynes' *Collected Writings*, vol. XXIX, which has appeared in the interim. Yeager's *"Reply"* makes clear, however, that mere reassertion plus that reference will not do. I owe him an explanation of how it fits in.

I do not want to argue that Keynes "was right all along." So that is not the issue. What is at issue is the theme of my 1968 book which maintained that the *General Theory* contained a novel and important theoretical idea, that this idea was central to Keynes' conception, and that this idea was not developed, or even preserved, in the later development of Keynesian economics. This "promise which the Keynesian tradition has not fulfilled" (p. 386) inheres in the idea of "effective demand failures."

In his 1973 "Keynesian Diversion" article, Professor Yeager declared that, on his reading of Keynes, while much in the *General Theory* strikingly resembles "the supposedly vulgar Keynesianism of the income-expenditure theory," Keynes "falls short of articulating any-

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thing resembling . . . the Clower-Leijonhufvud story." Similarly, Professor Grossman's 1972 review article, "Was Keynes a Keynesian?", concludes that "the most plausible answer" to the question of its title "is that Keynes did not have in mind anything resembling Clower's interpretation of the consumption function . . . and that he had no vision of the sort attributed to him by Leijonhufvud." And Yeager now quotes the late Alan Coddington (in his 1976 article) as finding our interpretation to be the result of "reading not so much between the lines as off the edge of the page."[1] This line is so witty, it is rather a pity that it misses the whole book!

At the time I was writing, the established interpretation of Keynes was that he had explained unemployment by postulating rigid wages. (Today this is also the re-established interpretation—one sees this old canard repeated almost wherever Keynesian economics still rates a mention.) The rigid wages hypothesis was *not* a novel idea in Keynes' day. That the explanation of why labor fails to sell must start from the presumption that wages are too high and won't come down is a notion that is in all probability older than is economics as a discipline. The idea that Keynes sought to differentiate himself from the "Classics" and start a "revolution" by reasserting this old platitude is not necessarily the "most plausible" reading of the *General Theory*—particularly since it is definitely to be found only "off the edge of the page."

In 1968, I tried to show that there was a theoretically far more interesting, alternative reading of the *General Theory* and therefore—and this was really the point—that there had existed in 1936 an "alternative future" for Keynesian economics to the one realized. I did confess (rather too readily and too often, I now think) that this alternative reading was "speculative" rather than literal on some points. But I also maintained that it made more sense. In particular, it allowed a coherent interpretation of how Keynes did differentiate himself from the "Classics," where no such coherent interpretation was previously available.

Mass unemployment is a symptom of coordination failure. "Wrong" prices that won't budge is one possible explanation of such failures. Another possibility, the one that Clower and I explored, is that freely competitive, flexible prices might fail to move in such a manner as to generate the price signals required to coordinate activities. The "market forces" governing the adjustment of prices (and of rates of output, employment, and consumption) will not always drive prices

[1]This was said about Clower, but it was undoubtedly intended that I should feel guilt by association.

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toward the equilibrium configuration where the desired transactions of all parties are consistent. Although there are no obstacles to price movements, the price system may thus fail to communicate all the information required to enable agents to exhaust potential gains from trade.[2]

In an imaginary economy so organized that the offer of any particular good would constitute an "effective" demand for any other good desired by the supplier, such effective demand failures would not occur. They occur in systems where money appears on one side of all transactions and thus is the only good traded in all markets. For an individual agent in a money economy, the sale of labor and purchase of wage-goods, for instance, must then be separated by the acquisition and disposal of money; whether the agent's desire to acquire wage-goods is communicated as an effective demand thus becomes conditional on the realization of the sale of labor. To capture the theoretical possibility of this kind of coordination problem, therefore, it is vital to think in terms of a model in which money is *the* means of exchange. "Barter" models will not do.

Today, the New Classical Economics has made it utterly commonplace to discuss macroeconomic problems from this information perspective. (This is so even though the New Classicals have waved the magic wand of rational expectations over most of the things that Clower and I thought of as information problems—and have thus made them vanish from discussion.) In the mid-1960s, no one wrote about Keynesian unemployment or other macroeconomic issues in those terms. So the contention that Keynes had thought in such sophisticated "modern" terms already 30 years earlier was received with the suspicion to which Yeager, Grossman, and Coddington gave expression.

I came to consider the question whether all this "was in Keynes" quite late in my own work. (Chapter II:3 of my 1968 book was not part of my dissertation.) At that stage, I would not have been averse to claim the originality that Yeager in 1973 sought to accord me! But in revising my manuscript for publication I had to form a judgment on the question. A careful rereading of the *General Theory*, chapter 2, "The Postulates of the Classical Economics," was more convincing than anticipated. From the standpoint of the theory of effective demand

[2]The occurrence of "false trading" at the prices of the moment is a link in the chain of argument. But the theoretical emphasis is altogether on whether adjustments of prices have the system heading toward full employment or not. The orientation, therefore, is very different from that of the literature on fix-price general equilibrium rationing models developed by Barro and Grossman, Siven, and the French school of Benassy and Malinvaud.

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failures, the chapter made perfect sense. Moreover, all of Keynes' objections to "Classical" theory were part and parcel of the same argument.

It was clear what Keynes' definition of "involuntary unemployment" meant and why he had phrased it in such a seemingly awkward, contrived way. It was clear why he harped on Professor Pigou treating the wage-bargain as if it were a barter bargain when he (Pigou) knew it was a money bargain. It was clear what were Keynes' objections to Say's Law (unemployed labor is not an effective demand for wage goods, and current saving does not constitute effective demand for future consumption). And, finally, it was clear why he claimed that the three "Classical" assumptions, which he argued must be discarded, "all amount to the same thing in the sense that they all stand and fall together, any one of them logically involving the other two" (GT, p. 22).

As far as I am aware, there is to this day no alternative interpretation of Keynes' chapter 2 in the literature which makes *coherent* sense of it. Almost all authors simply ignore Keynes' elaborate definition of involuntary unemployment and substitute their own opinion of what the words might usefully (or, in the case of Lucas, uselessly)[3] mean; most of them end up thus labelling some concept of unemployment that Keynes went to the pains of explicitly listing as "voluntary." Some have read his discussion of why Pigou is unjustified in treating wage negotiations as dealing with exchanges of labor for wage-goods as showing that he assumed the labor-supply decision (but not the consumption decision) to be affected by money illusion. And the most common interpretation of his attacks on Say's Law has been that he was attacking Say's Law in the sense (or nonsense[4]) *later* invented by Oskar Lange. This makes Keynes' critique of "Classical" theory, I noted (p. 101), into a "motley assortment of outlandish propositions." Hence,

> One must conclude, I believe, that Keynes' theory, although obscurely expressed and doubtlessly not all that clear even in his own mind, was still in substance that to which Clower has recently given a precise statement [p. 102].

This is the conclusion to which Yeager, Grossman, and Coddington take exception. (None of them, however, has tried his own hand at making sense of chapter 2.)

[3]Lucas (1978) argues the uselessness of the concept of "involuntary unemployment." I have discussed the matter in my 1983 article (pp. 195–99).

[4]For a detailed discussion of Lange's concept and some of the damage it has done to textbook Keynesianism, cf. Robert Clower and Axel Leijonhufvud, "Say's Principle: What It Means and Does Not Mean" (1973).

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Still, I had to admit, an argument that rests on coherence of interpretation does not compel assent. If Grossman, Yeager, and others did not accept it, I could not very well force them to do so. My interpretation did involve a fair amount of reading between the lines. Some scholars will object to anything but a literal reading, but I see nothing illegitimate about it—it is, literally, the only *"inter-legent"* thing to do. But why, if this was his message in substance, did not Keynes spell it out more clearly?

Some things he did not need to go into. In trying to understand the relationship between Keynesian macroeconomics and the neo-Walrasian general equilibrium theory of the early 1960s, Clower and I came to delve into such matters as the absence of the Walrasian auctioneer, "false trading," and the appearance of realized sales-proceeds in the (consumption) demand function. There is no reason why someone, coming to the problem from a Marshallian background in the 1930s, should have trod this tortuous path. Alfred Marshall's demand function, for instance, was constrained by realized income to begin with.[5] So there are a number of elements of the 1960s discussion that one should not expect to find paralleled in the *General Theory*.

Nonetheless, before *The Collected Writings* had appeared, the evidence that Keynes had a clear conception of effective demand failures was too a large extent indirect. Keynes could so easily have made the matter indubitable by some simple illustrative example—but had not done so. I put my classroom examples into print to help make the point. The posited context was a state in which, at today's (fix-)prices, the supply of labor exceeds employment and the supply of wage goods is exceeded by the demand—if in the latter we include what the employed would have bought had they found jobs. Why should we not predict tomorrow's wage to be set lower *and tomor-*

[5]Grossman's conclusion was, in part, that "[most plausibly] . . . Keynes did not have in mind anything resembling Clower's interpretation of the consumption function. . . . Keynes surely did not appreciate the essential sense in which it was inconsistent with the classical theory of markets." It is not easy to appraise it briefly. It is almost certainly true that Keynes had given little or no thought to the various logical inconsistencies that would arise if his consumption function was somehow plunked down in the midst of a Walrasian general equilibrium model. But he certainly knew (and said so) that his theory was inconsistent with Say's Law of Markets and, of course, that his consumption function was crucial to the thoroughly anti-classical deviation-amplifying multiplier.

Grossman correctly pointed out that my characterization of Keynesian short-run dynamics as "a reversal of Marshall's ranking of price- and quantity-adjustment speeds" could not be true in general, or Keynes would not have had his labor demand function coincide with the marginal productivity of labor schedule. I stand corrected on this point. But it does not follow from it that Keynes did not have a theory of effective demand failure.

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row's wage good prices higher and tomorrow's quantities to be moving smoothly in the directions required to eliminate the "rationing" due to the initial pricing mistakes?

> Clearly, because in that [Keynesian] system *all exchanges involve money on one side of the transaction.* The workers looking for jobs ask for *money,* not for commodities. Their notional demand for commodities is *not communicated* to producers. . . . The individual steel-producer cannot pay a newly hired worker by handing over to him his physical product (nor will the worker try to feed his family on a ton-and-a-half of cold-rolled sheet a week). . . .
>
> In an economy of self-employed artisans our problem simply cannot appear. If it does appear in a posited system, say, of big farmers "higgling and haggling" with prospective farm-hands over the room and board and other direct material benefits that are to constitute the real wage, it will be most smoothly solved in a thoroughly Walrasian manner. [1968, pp. 89–91]

I could not find anything that plain in Keynes[6] and that left a nagging doubt. I have told the rest of the story before but without putting it fully into context (as I have here tried to do). To repeat (1983, p. 198n):

> When Volumes XIII and XIV of the *Collected Writings* appeared, I skimmed them solely to see whether my interpolations had been too imaginative. Somewhat to my consternation, I could not find anything that seemed relevant to the problem one way or another! In the Fall of 1974, I visited Cambridge . . . and took the opportunity of a dinner at King's to ask my host, Lord Kahn, and also Lord Kaldor and Professor Robinson whether the Circus had not discussed Chapter 2 of the *General Theory* and why no background material had come to light. They did not recall any such discussions—which left me somewhat mystified.
>
> Some time ago, Mr. C.W.S. Torr brought to my attention that the 'Tilton laundry hamper' had contained the answer. Much of Vol. XXIX is devoted to some discarded introductions to the *General Theory* in which 'the contrast between a Co-operative and an Entrepreneur Economy' is treated as fundamental.
>
> Keynes's 'Co-operative Economy,' as it turned out, was one in which labor is bartered for goods, so that the supply of labor is always an effective demand for goods. In his 'Entrepreneur Economy' the Clowerian rule applies: labor buys money and money buys goods but labor does not buy goods. In the entrepreneur economy,

[6] For the *other* effective demand failure (the intertemporal one), Keynes did come up with a homely, to-the-point illustration;

> An act of individual saving means—so to speak—a decision not to have dinner today. But it does *not* necessitate a decision to have dinner or buy a pair of boots a week hence or a year hence or to consume any specified thing at any specified date... [GT, p. 210].

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> therefore, effective demand failures are possible and so, consequently, is 'involuntary unemployment.'
>
> That, I think, should settle the matter. See Keynes (1979), pp. 63–102.

My own reaction to reading the volume XXIX materials was that of at last coming on a piece of the puzzle that I had long conjectured should have existed! The contrasts drawn between the "Cooperative Economy" (in some places also called the "Real-Wage Economy") and the "Entrepreneurial Economy" involved precisely the simple, straight-forward, unmistakeable conceptual experiments that had been missing. Hence my statement in commenting on Yeager: "it so happens that on these particular points we now do know precisely what [Keynes] meant" (1986, p. 415).

Yeager does not think so. His *"Reply"* asks:

> [W]hat significance attaches to what Keynes said or supposedly said or supposedly meant in rough drafts that he *discarded*? The fact that he wrote certain ideas down, considered them, and then *discarded* them would suggest that they were *not* what he meant.

Ignoring what did not get into print, Yeager's conclusion suggests, would "serve the integrity of the history of economic thought and also the very substance of money/macro theory." Indeed!

Yeager ends on a rhetorical note, ". . . is it not time at last to give up the delusion that Keynes really had his theory right all along?" There are two, somewhat related, delusions that I most definitely would not want to propagate. One is that all the novel theoretical ideas in the *General Theory* were correct and valuable. Keynes' Liquidity Preference hypothesis of interest rate determination, for instance, I consider to be "theoretically unsound, empirically false, and practically dangerous."[7] I also part from Keynes on the scope of the effective demand failure possibilities discussed above.[8] The other delusion is that, in trying to understand the development of our subject, we should assume that Keynes (or anyone else) had powers of logical closure, i.e., presuppose that he understood fully all the logical implications of a theoretical structure, whether his own or one of those, such as IS-LM, that were proposed by others as interpretations of his thought. But I also regard it as a delusion that Keynes had nothing worthwhile to contribute.

Yeager is simply unwilling to consider Keynes' understanding of "monetary disequilibrium" as on a par with that of Harry Gunnison Brown, Herbert J. Davenport, or Clark Warburton. Yet, it is hard to

[7] Leijonhufvud, "The Wicksell Connection" (1981, p. 195).

[8] See Leijonhufvud (1973).

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find anything in the picture Yeager gives of their theories beyond the Quantity Theory with "frictions," albeit intelligently elaborated. Keynes, too, has written intelligently in this *genre*. His *Tract on Monetary Reform* belongs to it. By the *General Theory*, his theory has become more complicated: a generalized excess demand for money may result not just from a contraction of the money supply but also from an increase in the amount demanded induced by real shocks; in the case of a real intertemporal (saving-investment) disequilibrium, a new relative price vector has to be found for equilibrium to be restored, so simply a balanced deflation will not do; even in the absence of significant "frictions," the adjustment process may fail to home in on the equilibrium price vector because of effective excess demand failures.

Keynes did not get all this "right all along." But he was venturing (as we now have every reason to know) into exceedingly difficult territory. The questions that he tackled were not of the sort that would have better been ignored. Monetarism highlights some basic truths that should not be lost from sight—as, admittedly, they tended to be at times during the high tide of Keynesianism. But we also have to be concerned about real shocks, about intertemporal coordination problems, and about effective demand failures. A macroeconomic theory that grapples seriously with these problems is not just a useless diversion.

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BOOK REVIEWS

The Peasant Betrayed
John P. Powelson and Richard Stock
Boston: Oelgeschlager, Gunn, & Hain
for the Lincoln Institute of Land Policy,
1987, 302 pp.

In its dream version, land reform releases peasants from the iron grip of rapacious landlords, supplies each with a modest but sufficient plot of land, and lays the foundation for an agricultural economy of productive, self-reliant yeomen, the bedrock of future democracy. The real world, as portrayed by John P. Powelson and Richard Stock is quite different. It brings to mind Macauley's exclamation: "Reform! Don't speak to me of reform, sir. Things are bad enough as they are." Virtually everywhere, land reform appears instead to have replaced multiple rapacious landlords, in at least implicit competition with each other for tenants, with a single rapacious landlord—the state.

Typically the state grants the supposed beneficiaries only a fragmentary title—*they lose it if they cease to farm, so they cannot leave without* abandoning whatever wealth the farm represents. They are tied to the land nearly as tightly as the medieval serf. Then the state squeezes them at both ends of the production cycle. It commonly establishes monopolies over the sale of fertilizer and over purchase of the important crops. Selling high and buying cheap, the state denies the peasant what the market would allow him. Finally, it interferes in credit markets, sometimes monopolizing them, sometimes merely using subsidies to sap private markets of the ability to compete.

That's average. Some countries do worse. Bureaucrats in the national capital decide for the farmers what to plant, and when, what fertilizer to use, and when and where to sell. Thus the farmer in Egypt functions as no more than an employee of the state. Agricultural production in Egypt has *fallen* an average of 0.4 percent a year for 19 years. Mexico's agricultural output was less in the mid-1980s than in the early 1960s.

Even the occasional nonexploitative government agency brings ill. When an agency provides an input below cost, demand typically exceeds supply. Bribes and influence-peddling are needed to align them. The bribes are

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costly, and the atmosphere of corruption and favoritism diverts energy from productive activity.

Why such a dreary record? Powelson and Stock develop the thesis that land reform will succeed only where the peasant has already achieved considerable economic power and can seize it for himself; where the state "gives" him land reform, it will betray him.

The authors' thesis has a good deal of intuitive appeal. Peasants will have power where they have developed the skills of self-reliance and enterprise that make for success in the economic and political realms. If they have those skills, they will be likely to be able to fight off the manipulations of those social classes in whose interest the state establishes monopolies and micro-supervision over agriculture. (These assertions of state power are of course done in the name of helping the peasant; even apart from their evident failure to do so, the fact that they shift power away from the peasant producers would give ample ground for skepticism.)

If Powelson and Stock are correct, it is utterly quixotic to exhort Third World countries to adopt "sound" land reform. If the conditions of sound land reform exist, the peasants will bring it off. If they do not, those who control the state will twist it to their own purposes. Thus such exhortations would fall into a class with John Kenneth Galbraith's idea that socialist enterprises should be managed according to profit-seeking criteria, an idea that simply ignores the problem of how an enterprise in the political realm could ever be free of politics' normal system of rewards and penalties.

The character of past western interventions underscores these doubts about any possible future exhortations. In South Korea, for example, the American supply of grain under Public Law 480 provided political cover for an outrageous (but quite common) policy. The government monopoly over grain purchases paid the peasants below-market prices, thereby discouraging production. American grain filled the artificial gap.

The World Bank is also active in pushing Third World countries in doubtful directions. It promotes the idea that government must supply credit and "complementary inputs." Its thesis seems to be that these needs could not possibly be met either by existing indigenous institutions or by ones that would arise if government kept out. (The evidence is the other way, in the few situations where the state has left some room—such as Kerala (India) and parts of Bolivia.)

As is so often true, the authors' proof of their central thesis is not so strong as one could hope. Consider South Korea, which they rank high, as do most others. Their key explanation is that the largest landowners were tainted by collaboration with the Japanese, so that "no strong rural elite remained to co-opt government institutions." Together with the peasants' sense of self-reliance from their own anti-Japanese activities, this suggests a relatively powerful peasantry and fits the thesis. But the book does little to establish the unspoken premise that elsewhere it was the ousted landlords who manipulated land reform into a device for enhancing state power at the expense of the peasants. The chapters on land reform in other countries only rarely

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discuss those individuals' social or economic origins. One supposes them to be a Third World version of Irving Kristol's "new class," but where do they come from?

Further, some of the evidence of peasant independence in South Korea appears forced. The authors note that many peasants actually bought out their landlords. To the extent they did, land reform was indeed a product of the peasantry, operating within a constant system of private property rights, rather than of the government. But Powelson and Stock also point out that the peasants' bargaining power was enhanced by the government land acquisition plans, that the government delay in redeeming bonds used for land purchases warned landlords that they would not receive full market value, and finally that a peasant rent strike (evidently enjoying the benefit of government failure to enforce landlords' rights) undercut the landlords' expectations from continued ownership. It was bargaining, but the government thumb was on the scale.

In addition, the South Korean success is itself somewhat blighted. As the story of underpricing reflects, even there the government took over related economic activities at the expense of the peasantry. Taiwan, the other reputed success story, also introduced government fertilizer and rice monopolies, and pursued the usual price-squeeze policy. The authors note that both South Korea and Taiwan introduced these monopoly programs well after the land reforms and in some sense independently of them. But the programs were still destructive, though delayed, and their adoption shows that the peasantry lacked the political power needed to protect themselves.

Supporting the authors' thesis, however, is the fact of rapid industrialization in South Korea and Taiwan. Peasants' economic opportunities off the farm represent a basic source of protection; they need not tolerate treatment that makes them worse off than under an alternative. Successful industrialization raised the returns to alternative activities.

The authors cite one other partial success—areas of Bolivia where the rebellious character of the peasants, and land's barrenness and distance from population centers, left the government disinclined to meddle. There, a fairly complex set of peasant institutions developed, including a union, meeting the peasants' needs for marketing and credit. If Powelson and Stock are correct, the World Bank's skepticism and condescension have no basis.

Another bizarre case is that of Kerala, India. A nominally Marxist regional government, functioning under India's version of federalism, expropriated its rentier class of owners and redistributed the land among working farmers. Rich peasants gained the most, followed by poorer ones, with the smallest (but not invisible) gains going to the *kudikida pukars*—the poorest of the poor. For reasons not altogether clear, the defects of the government credit system were at least milder in Kerala than elsewhere in India and the Third World. The authors believe that "participatory democracy," not described in detail, enabled the local farmers to keep control. The relative prosperity of the farmers whose interests prevailed also tends to support the authors' theme: where the peasant beneficiaries have a fair bit of economic and political power at the outset, reform is less likely to be captured by the state.

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The Peasant Betrayed is a somewhat formidable book, not to be undertaken by the faint-hearted. But, besides amassing an abundance of information, it raises vital questions for anyone concerned with Third World development and the role of the West.

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A Nation in Debt: Economists Debate the Federal Budget Deficit
Richard H. Fink and Jack C. High, eds.
Frederick, Md.: University Publications of America, 1987, 300 pp.

Twenty years ago, economists were asking: "Does money matter?" At the time, the international monetary system was rooted in the gold standard and a system of fixed exchange rates under the Bretton Woods agreements. This provided for some degree of stability and predictability of monetary policy that persisted until the system broke down in the early 1970s. The remainder of that decade witnessed a failed attempt in the United States to manage the nation's monetary policy. The consequences were high inflation and interest rates, volatile and generally slow economic growth, and sagging productivity. By the end of the decade, the uncertainty and pessimism about the future seemed to be a confirmation (for those who needed it) that the answer to the question is "yes." Money not only matters, but it can matter a great deal.[1]

During the 1980s, it could be argued that there has been an improvement on the monetary side of U.S. economic policy. That is, while price stability has not been restored and uncertainty over policy decisions remains, both the level and the volatility of inflation have fallen. However, the economy is now exposed to the large structural budget deficit of the federal government. This suggests that some of the earlier mismanagement may have shifted to the fiscal side of the nation's economic policy-making. As a consequence, economists are now asking an old question with renewed interest: "Do budget deficits matter?" The timely collection of essays assembled by Richard Fink and Jack High addresses this question.

There seem to be two overriding concerns that went into the selection of these essays. One is to provide a historical perspective on the issues surrounding deficit spending. In this regard, the book is very successful. Even those intimately familiar with the current debates will likely find something new and of interest, particularly in the first two chapters. I was surprised to learn, for example, of the important role that government debt issues played in the early development of organized capital markets in Great Britain (pp. 52–57).

[1]This is not to suggest that *only* money matters. Other policy- and non-policy-induced shocks, for example, those related to regulatory uncertainty and OPEC pricing, also had significant effects on the real economy during the 1970s.

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The second concern is to provide a nontechnical and balanced treatment of the issues. Once again, the book generally achieves this objective, although my impression is that one is likely to come away from the book viewing the deficit as an institutional problem of major importance that needs correcting. While this may be the only proper conclusion one can draw, I did experience one minor frustration on this point. Many of the essays in the book are drawn from the popular press. While the objective of presenting the issues in a nontechnical fashion makes this understandable, it leaves sections of the book vulnerable to accusations of an overstatement of positions and a general glossing-over of important and substantive views.

With no discredit intended, an example is the article by Paul Craig Roberts (pp. 83–86) entitled "Why the Deficit Hysteria Is Unjustified." The intention of that article was apparently to defuse criticism of the 1981 tax cuts by diverting attention to monetary policy. In passing, Roberts itemizes a number of positions taken by academic researchers, including Robert Eisner and Charles Plosser, that stress the relative insignificance of budget deficits on the economy. The casual reader might wrongly infer that Eisner and Plosser would have similar policy prescriptions, and that those would conform to the "supply-side" agenda of Roberts. We are subsequently given a discussion of Eisner's view (pp. 87–101), but not of Plosser's, nor of Evans's, nor of Barro's (which for unknown reasons, Roberts failed to mention). While the popular press has tended to focus on the views expounded by Paul Volcker regarding the consequences of large budget deficits, which are also included in the book (pp. 154–61), and to which Roberts was no doubt reacting, the important debates in academic circles focus on the research of Evans, Plosser, and Barro. It is the relative inattention to their work that constitutes my only serious criticism of the book.

The organization of the book is exceptional. The issues surrounding deficit spending are developed historically in a more or less "point-counterpoint" fashion. Chapter 1 includes extracts from Adam Smith's *Wealth of Nations* and Karl Marx's *Das Kapital*. It is interesting to note that the undesirability of the government's freedom to issue debt may constitute the only point on which these two men would ever have agreed. On my rereading of Adam Smith, I was once again impressed with just how "modern" his views have remained. At the time of his writing, Britain had, for the first time, accumulated a significant amount of "war debts," the consequences of which were largely unknown. In his analysis of this problem, Smith discusses how the government's freedom to issue debt places an upward bias on government spending and taxation. He also describes the consequences this has on private incentives, due (in part) to the destruction of private property rights. Smith further discusses why political expediency will lead to increasing monetization of these debt issues. Monetization represents a transfer from creditors to debtors, and as the latter are larger in number, they give the policy a greater constituency.

Chapter 2 traces the emergence of stabilization policy out of the economics of J. M. Keynes. It presents his views, the context in which they were

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developed, their evolution into the "functional finance" of Abba Lerner, and their diminishing influence as predicted by Ludwig von Mises. Chapters 3 and 4 present a wide range of views on the subject of deficit spending with essays by no less than four Nobel Laureates (Friedman, Hayek, Tobin, and Buchanan) whose views are all quite distinct. With the exception noted earlier, I found these chapters to be a comprehensive and balanced treatment of the principal issues surrounding the significance, causes, and consequences of deficit spending.

Chapters 5 through 7 round out the collection with a focus on political and institutional reform. Most of these essays take the position that deficit spending is symptomatic of a larger problem of a government that lacks the structure required for self-discipline and self-restraint. Without substantive reforms, government spending and taxation will continue to rise, and economic growth that is founded on personal initiative will stagnate. These essays discuss the effectiveness and the feasibility of various reforms, including constitutional amendments to balance the budget and limit the growth of taxation, legislative reforms mandating "supermajorities" for enactment of spending and taxing bills, and measures that would impose greater control over the budget process. These are all important issues that deserve the attention of our elected representatives in Congress. In sum, I would recommend this book as a useful collection of essays that deserves the attention of those of us who are being "represented."

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The New Protectionist Threat to World Welfare
Dominick Salvatore, ed.
New York: North-Holland/Elsevier Science Publishing Co., 1987, xvi + 581 pp.

I did not like this book and quickly regretted having agreed to spend the time necessary to review it. It is a mixed bag, though, and some of the articles in it are worth reading, as I'll explain.

Writings on the "real" (as opposed to monetary) side of international economics generally fall into either of two categories: (1) exercises in high-powered price theory and (2) a blend of economics with political and institutional description and self-conscious, moralizing internationalism. Most of this book falls into the second category.

As its title should have warned me, the book is full of complaints. Countries are backsliding from the noble ideals of the GATT and the diplomats who negotiated tariff cuts under its auspices. Protectionists are resorting more and more to sneaky measures such as import quotas, "voluntary" export restraints imposed on foreign suppliers, orderly marketing arrangements, and miscellaneous disguised restraints on imports. It is desirable, urgent, imperative—whatever—that governments abandon their wicked ways and adopt liberal trade regimes; such trade barriers as do remain should be nondiscriminatory and "transparent" (i.e., forthright, undisguised).

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So what else is new? I agree with the sentiments expressed by so many of Salvatore's authors. I too am no nasty protectionist; I too am on the side of the angels. But reassuring each other on this point quickly becomes tedious, tedious, tedious. By now, after over 200 years, economists should be accustomed to seeing their free-trade advice scorned.

With few and partial exceptions, Salvatore's authors do not invoke the lessons of public-choice theory. Of course governments, especially democratic governments, keep handing out protection and other conspicuous favors to vocal minorities, diffusing the greater total costs inconspicuously over the general population. Any hope, it seems to me, must rest not on the sort of piecemeal preaching found in this book but on cultivation of a constitutional attitude and perhaps adoption of a constitutional amendment restraining the economic powers of government. Perhaps the public can be persuaded of a general principle, like freedom of speech or governmental restraint in economic affairs, when the argument is conducted on the level of principle, even though, otherwise, interventions in innumerable individual cases would seem like plain common sense.

When politicians, journalists, and the stray economist recommend further extension of government economic activity—as under an "industrial policy"—we skeptics should call for a look at the record. How well have governments performed in trade policy, farm policy, synfuels and other energy policies, tax policy, and so forth? Do you interventionists really want to extend the scope for that sort of performance? Or if you do think that governments can perform a constructive role in "targeting" on certain industries by favoring them with protection, subsidies, cheap credit, guaranteed markets, and so forth, precisely how do you propose to change the environment of information and incentives affecting policymakers so as to obtain better results than in the past?

Asking such questions does not convey any assertion that the unhampered market operates so perfectly that no interventions could conceivably make any improvement. So-called imperfections do exist in the real world, and it is a routine exercise for any even half-way competent economist to think up interventions that would bring improvements in abstractly conceived cases. But what do such abstract possibilities imply for policy in the real world, in which government decisionmakers are not omniscient and omnipotent and thoroughly public-spirited and do operate with inappropriate incentives and fragmented responsibilities?

Around the middle of the book, barely in time to keep me from dismissing it with a curt, scathing review, the articles by Richard Cooper, Paul Krugman, and Mordechai Kreinin do begin to touch on such questions. Cooper emphasizes something that ought to be obvious but apparently often escapes politicians and other noneconomists, namely, general economic interdependence. "Discrimination in favor of certain firms or industries automatically involves discrimination against firms and industries that are not specially favored. If subsidies or tax breaks or below-market credits are given to favored firms, others have to make up the difference by paying more taxes or more

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for credit than would be true in the absence of the discriminatory measures. And the currency will appreciate to the extent that exports are stimulated, thus putting others at a disadvantage with respect to foreign competition" (p. 249). "U.S. actions should not be motivated by arguments that rest on the fallacy of composition—that is, that the action would generate employment or improve the overall trade balance. Except in the short run, employment and the overall trade balance are determined by the macroeconomic conditions of each economy, not by particular trade policies" (p. 258). (This point seems to have escaped Darryl McLeod and Dominick Salvatore in their article on employment effects of barriers to North-South trade. They grind out conclusions from abstract models of economies constrained by deficiencies of demand or of capital, suffering from savings gaps or foreign-exchange gaps, and exhibiting Keynesian multipliers in operation—all without duly distinguishing between *patterns* of economic activity and *levels* of activity or idleness and without being explicit about assumptions concerning wage and price stickiness.)

Paul Krugman examines "Targeted Industrial Policies: Theory and Evidence." He classifies criteria for selecting industries to be favored into two groups—"popular" ones advanced in arguments aimed at a large audience and "sophisticated" ones suggested by economic theory. Implementing two of the popular criteria would be "disastrously counterproductive," while the other two of the four that Krugman finds in circulation would be less obviously destructive, but not likely to be beneficial, either. Yet "when the time to choose industrial targets comes, it will be a break with all past experience if the criteria for selection are more sophisticated than these" (p. 276). The relatively sophisticated arguments invoke economies of scale and imperfect competition, externalities, and possibilities of correcting for the adverse effects of other government policies. (Some of these concepts enter into arguments for "strategic" trade policy, which is something of a buzz word nowadays; but those arguments strike me as providing nothing beyond new packaging for old and familiar abstract-theoretical arguments for protection.) Anyway, Krugman concludes that even the sophisticated case for industrial targeting "does not look very operational" (p. 281). After a historical review, he finds "no clear-cut cases of successful industrial targeting. Of the two most famous examples, Japanese targeting of steel probably reduced national income, while the returns are not yet in on Japan's targeting of semiconductors" (p. 295).

Michael Mussa also stresses the implications of general economic interdependence, including interdependence over time. He identifies the "misapprehension" that protectionist commercial policies can provide not only protection for particular domestic industries but also positive average protection for domestic industry. In addition to his article, four others in the book are more concerned with money and exchange rates than with the microeconomic aspects of protectionism.

At least a couple of articles in the book take cookbook econometrics seriously to the point of being laughable. Gershon Feder and Lily Uy run regres-

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sions in which the dependent variable is a measure of "country creditworthiness" not further explained than as being published every six months by *Institutional Investor* on the basis of a survey among bankers and financial institutions. The supposed explanatory variables include various ratios and other numbers and dummies. The authors use the coefficients that pop out of their computer to construct a model of a hypothetical economy and then run simulations that generate several tables of numbers.

The space of a review does not permit meaningful comment on every one of twenty-six articles. Each of the unmentioned authors is free to believe that his (not "his or hers," in the present case) is one of the exceptions I found to the dreariness of the book as a whole.

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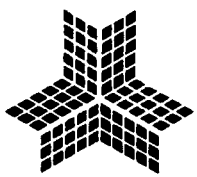

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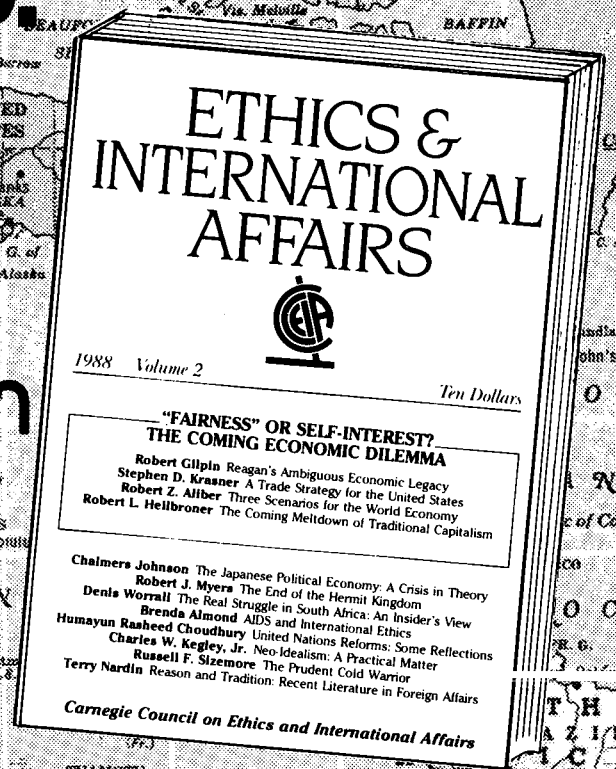
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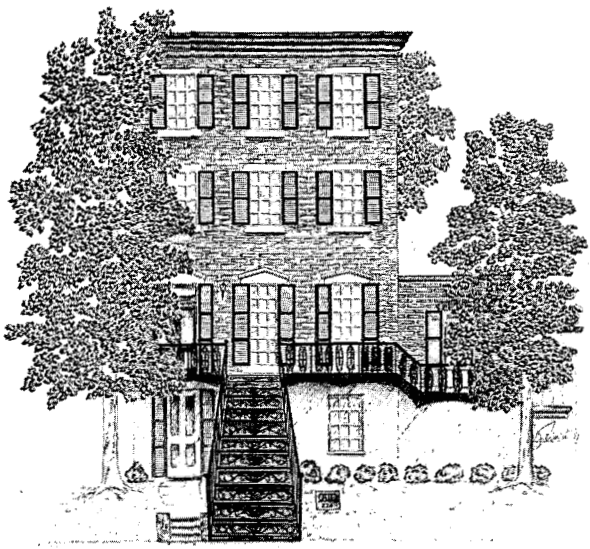

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FREEDOM AND CONSTITUTIONAL CHOICE

To be free to act as one chooses and at the same time to recognize the freedom of others to do likewise can only mean that all participate equally in setting the constraints upon individual action. For no one is free unless all abide by the rules of conduct which all can be brought to accept as appropriate constraints upon individual action. . . . To require of each individual that he takes no action which impairs the freedom of any other individual is to accept the moral principle that no individual should treat another simply as a means to an end. Each individual chooses the rules and principles for the guidance of his conduct, but he does so under the general principle that no rule of action will be adopted which could not be universally adopted by all individuals. . . . Hence, when we think of a free and rational individual we do not envisage an individual unconstrained by law but rather an individual who acts in accordance with rules of conduct he has chosen. . . . [These] ideas . . . were presented as implications of the concept of individual freedom at about the time this nation was formed; and the political structure of the U.S.A. reflects this conception of freedom and rationality.

—Rutledge Vining

Economics in the United States of America
(Paris: United Nations Educational,
Scientific and Cultural Organization,
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